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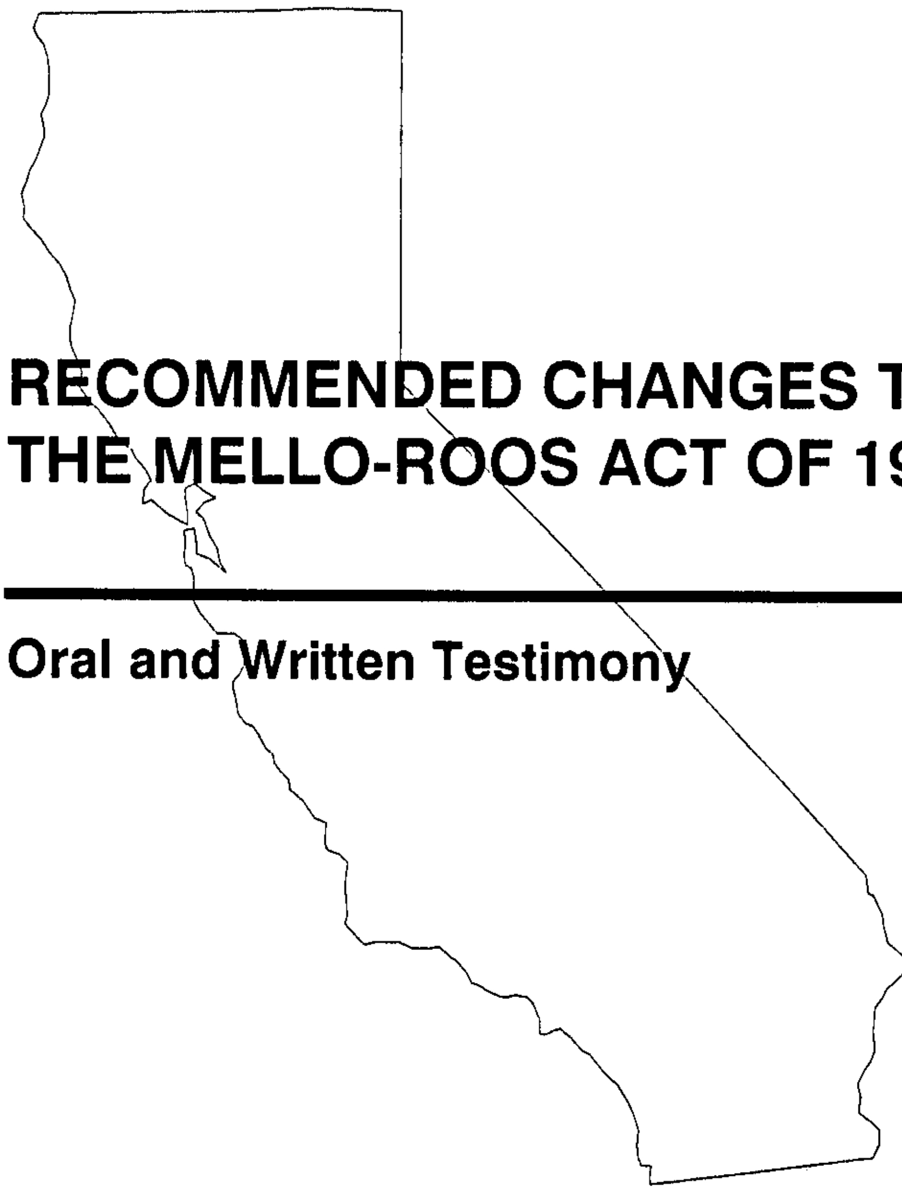

RECOMMENDED CHANGES TO THE MELLO-ROOS ACT OF 1982

Oral and Written Testimony

Kathleen Brown
California State Treasurer
and Chair

RECOMMENDED CHANGES TO THE MELLO-ROOS ACT OF 1982

Oral and Written Testimony

March 1992

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Steve Juarez
Executive Director

March 26, 1992

To All Interested Parties:

The California Debt Advisory Commission (CDAC) is pleased to release *Recommended Changes to the Mello-Roos Act of 1982: Oral and Written Testimony*, a report which includes the transcript of a hearing conducted by CDAC on January 15, 1992 on the Mello-Roos Act, and written comments received by CDAC regarding potential changes to the Act. This collection of statements should be viewed as a supplement to *Recommended Changes to the Mello-Roos Act of 1982: Report to the Legislature and Governor*, a separate CDAC report which is also available upon request.

The Mello-Roos Community Facilities Act of 1982 has been extremely valuable in helping local governments finance needed infrastructure improvements in California. To date, nearly $3.7 billion in Mello-Roos bonds have been issued by local agencies to fund roads, sewers, schools, and other public improvements. These bonds, which are repaid from a special tax on property, have been particularly popular in high-growth counties such as Riverside, San Bernardino, and Orange.

The expansive use of Mello-Roos financing, however, has created its share of concerns. With the downturn in our state's economy, bondholders have become increasingly worried about the underlying value of the property which secures these bonds. At the same time, some taxpayers have complained about the equity of Mello-Roos taxes and the overall burden being placed on homeowners in growing areas. Finally, the increased scrutiny of the press and the public has focused on questionable funding practices which undermine the integrity of the Mello-Roos financing process.

In response, CDAC conducted a hearing in January which explored many of the questions being raised. As a result of that hearing, and additional research undertaken by the CDAC staff, the Commission has issued a report to the Legislature and Governor outlining recommended changes to the Mello-Roos Act and identifying other related issues for their consideration. In order to provide a complete record, the Commission is releasing this supplemental report of testimony and written comments.

Sincerely,

Kathleen Brown

KATHLEEN BROWN
California State Treasurer
Chair, California Debt Advisory Commission

California Debt Advisory Commission

The California Debt Advisory Commission is the state's clearinghouse for public debt issuance information. The Commission was created by the California Legislature in 1981 to assist state and local government agencies with the monitoring, issuance, and management of public debt.

The California Debt Advisory Commission members include:

Additional information concerning this report or the program of the California Debt Advisory Commission may be obtained by contacting:

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Section I

Oral Testimony

Public Hearing

On The

Mello Roos Act

California Debt Advisory Commission

Santa Ana, California
January 15, 1992

CDAC HEARING ON THE MELLO-ROOS ACT
Orange County Hall of Administration
10 Civic Center Plaza
Santa Ana, California 92701
January 15, 1992
9:00 AM to 1:30 pm

FINAL AGENDA

I.	OPENING REMARKS:	State Treasurer Kathleen Brown
II.	TAXPAYER PERSPECTIVE:	Walter Hueck, Palmia
		John Beckley, Aliso Viejo
		Robert Beaulieu, Tracy
III.	PUBLIC AGENCY PERSPECTIVE:	Eileen Walsh, County of Orange
		Tim Davis, County of Riverside
		Ray Wood, Lake Elsinore
		David Doomey, Capistrano USD
		Mike Vail, Coalition for Adequate School Housing (CASH)
IV.	DEVELOPER PERSPECTIVE:	David Booher, California Council for Environmental & Economic Balance
		David Celestin, Orange County BIA
		Ursula Hyman, Latham & Watkins
V.	FINANCE PERSPECTIVE:	John Gibson/Scott Sollers, Stone & Youngberg
		Anthony Wetherbee, Chilton & O'Connor
		Harry Clark, Muni Financial Services
		David Taussig, Taussig & Associates
		Joe Evans, Empire Economics

VI.	LEGAL PERSPECTIVE:	George McFarlin, Orrick Herrington
		Marie Martineau, O'Melveny & Myers
VII.	CREDIT QUALITY PERSPECTIVE:	Greg Harrington, Franklin Fund
		Steve Zimmermann, Standard & Poor's
		David Ambler, Moody's Investors Service
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VIII.	LEGISLATIVE PERSPECTIVE:	Dean Mysczinski, California Research Bureau
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CDAC HEARING ON THE MELLO-ROOS ACT

Orange County Hall of Administration
10 Civic Center Plaza
Santa Ana, California 92701
9:00 AM to 1:30 PM

Kathleen Brown, State Treasurer
Chair, California Debt Advisory Commission

Brown: As most of you know the Commission recently issued a report on Mello-Roos bonds. This morning I would have been here a few minutes earlier, but I headed for San Pedro first. It looked fine. There was no problems in San Pedro, and we are now happily in Orange County. And I would like to introduce the members of the California Debt Advisory Commission that are here with us this morning. First, we have Sonoma County Treasurer Don Merz to my left, Anaheim Treasurer Mary Turner to my right. We will be joined, I understand, by Susie Burton from the Department of Finance, and I understand that Senator Marian Bergeson is going to be attending our hearing--is Senator Bergeson here as yet? I want to make sure to recognize her when she comes. She wants to listen to today's testimony which is the first step in our understanding of where we are with respect to Mello-Roos bonds. I would start with some opening comments with respect to the context of this morning's hearings. And first and foremost, I want to thank all of you for attending. I ran into Mike Roos last night, and he said to me "what are you doing with Mello-Roos bonds?" And I said, "just trying to protect your good name, Mr. Roos." And he seemed appreciative of that. One other person I want to introduce is David Hartley from Stone Youngberg who is the Chair of CDAC's Technical Advisory Committee--and thank you for being here, Mr. Hartley. You've been a great resource to us as has our entire technical advisory committee on the subject of Mello-Roos bonds.

Well, we're here today in Orange County at the one-decade point in the Mello-Roos Community Facilities Act of 1982. So I believe it is an appropriate time for taxpayers and local officials and municipal finance experts to come together and, in this forum, try to separate fact from fiction regarding this very important infrastructure tool. First and foremost, we must endeavor to educate our public about these bonds. Yes, there have been reported cases of abuses and at least one default. Potentially, taxpayers could end up paying money, significant sums, and bondholders could end up losing millions of dollars paying for bond deals gone awry, but these remain the exception. 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. But we must also keep our minds open that the problems that have occurred may represent a kind of early warning system. With the after shocks of the S&L crisis and scandals still being felt, it is not a time for closing our eyes or closing our minds to the possibility that reforms may be in order, both to protect California taxpayers and to preserve these bonds as an effective financing tool for at least another decade. So it is in that spirit that we will be looking at a number of things today. Among them, these bonds' credit worthiness, particularly in light of California's recent real estate slump. We'll be looking at the issue of tax equity which has been raised by many Mello-Roos homeowners who feel they're being required to pay more than their fair share. And what, if any, future roles should the state and local governments play in ensuring the proper use of these bonds and in protecting taxpayers from possible abuses.

What's the background of Mello-Roos bonds so that we have a context and a frame of reference? The Mello-Roos Act was enacted largely in response to the property tax limitations of Prop. 13. At the same time local governments were grappling with Prop. 13 shortfalls, the federal government sharply reduced funding for local infrastructure needs. The result: local officials with the responsibility for building infrastructure no longer had revenue sources to pay for it. And while Prop. 13 imposed limits on property taxes, no such limits were imposed on California's growth which during that period (since the adoption of Prop. 13 and the tax revolt)--since that period-- California has grown by 25 percent,enough to build six new cities the size of San Francisco. In response, the Legislature enacted the Mello-Roos Act. It provided a more flexible financing tool by permitting land owners/developers, upon receiving approval from a local government agency, to form a community facilities district, a CFD, as we'll probably be hearing about today, to levy a special tax and to authorize bonds secured by that special tax. As the properties in the Mello-Roos district are developed and sold, new homeowners assume the responsibility for paying the Mello-Roos special tax which is included on their property tax bills.

What's the status of Mello-Roos bonds today? Mello-Roos bonds have proved enormously popular, particularly in counties like Orange, Riverside and San Bernardino because these have been the California counties that have experienced much of the state's recent growth. Currently, there are $3.5 billion in outstanding Mello-Roos bonds providing the primary funding mechanisms for construction of everything from sewers and roads, to curbs and classrooms.

What are the concerns? But for all the benefits of our Mello-Roos bonds there are now some very serious concerns. Chief among them is the vulnerability of these land-backed securities, commonly known as dirt bonds, to economic downturns. Because they are secured by real estate, any decline in real estate values over the past year has added to the risks surrounding Mello-Roos financing. In addition, the decline in housing demands because of the recession means developers may be forced to hold on to newly developed properties longer than anticipated. If they become financially overextended as a result, the payment of debt service on outstanding Mello-Roos bonds may be threatened. And even Mother Nature has conspired against Mello-Roos bonds in the last decade as the state entered its fifth year of drought, which has reduced the number of building permits issued, which adds yet another burden on the Mello-Roos developers. Taxpayers have somewhat different concerns. For instance, the homeowners in a Mello-Roos district carry the burden of financing the facilities that sometimes benefit the broader community. This, they feel, means they are having to pay more than their fair share for public improvements. Secondly, there are complaints that the Mello-Roos tax formulas unfairly require homeowners to subsidize developers since developed and undeveloped land is taxed at different rates. Third, many landowners feel that the use of the landowner vote to form Mello-Roos districts amounts to "taxation without representation," despite provisions in the law which require that the tax be disclosed to home buyers.

What should we do? For all the concerns, there is one option, I believe, that should be taken off the table from the start: that is the outright elimination of this valuable financing tool. To do so would require the finding of new forms of revenue to pay for water and schools and roads; or face further gridlock on our highways; more children in our already overcrowded classrooms; more pollution; and a greater loss of business and jobs; and economic development. But there are things that we can look at. Among them, ways to lessen our reliance on Mello-Roos bonds. Perhaps, through the passage of a constitutional amendment, repealing the two-thirds requirement for infrastructure or for schools. The way to create tax equity may be to allow a return to "majority rule" when it comes to the passage of local general obligation bonds for schools or for other infrastructure needs. I'd like to hear your thoughts on that. Or we may need to look at new state and local regulations, including those outlined by CDAC which include guidelines for stricter standards for issuance, including minimum land value requirements, a guarantee of tax fairness so that taxes paid reflect the benefits received, tax rate limitations, the integration of Mello-Roos financings into overall government management strategies. And finally, we need to explore how to best ensure sufficient opportunities for democratic expression. Mello-Roos homeowners may vote with their feet in deciding to purchase homes in Mello-Roos districts, but that should not mean that they forfeit their right to influence tax and spending policies affecting their communities.

In conclusion, let me say it's my judgment that the Mello-Roos bonds have proved an effective financing tool over the last decade. But no tool is appropriate for all tasks, and sometimes even the best instruments eventually grow dull from overuse, from misuse or abuse. It's our job here today to take a fresh look at Mello-Roos bonds and to decide just how we might sharpen these tools so they can better be used for the growth and the infrastructure tasks that await California in the decade ahead.

And that, I hope, sets out the agenda, the concerns, the status and the context. I'd like to note that we have a sign-up sheet for public testimony to my left, up in the front, as well as a sheet whereby you may request forms for the report after this hearing, and we'd be happy to share that with you. Steve Juarez, who's the Executive Director of the California Debt Advisory Commission, is also here to assist in any administrative way that members of the public might need assistance. And I'd like now to ask if Treasurer Merz or Treasurer Turner would like to make any opening comments. Treasurer Merz?

Merz: No, I don't believe I have any at this time.

Brown: Great. And Treasurer Turner?

Turner: Not at this time.

Brown: And we've been joined by Susie Burton representing the Department of Finance. Welcome. Would you like to make any opening comment?

Burton: Not at all. Just here to learn.

Brown: Great. Thank you. Alright. Well, why don't we begin. We've tried to group the speakers by their perspective, if you will. And so first, we will be hearing from the taxpayers' perspective, then the public agency perspective. Then we'll hear from developers and a finance perspective. We'll hear from the lawyers, of course, and then get a credit quality perspective. Finally, a legislative perspective, and then we will turn to other members of the public. I would ask that you try and limit your remarks to the shortest, most concise framework. I think that as you can get to the point that you want to make as quickly as possible, we will be able to get more information into the record. So let me begin with Walter Hueck from Palmia, presenting a taxpayer perspective. Mr. Hueck.

Hueck: Thank you, Ms. Brown. Good. I would like to pass out a map here on 87-3, which will pertain to what I have to say.

Brown: Great. Thank you. Good morning. Please state your name for the record.

Hueck: My name is Walter Hueck. I'm with the Palmia Adult Community in Mission Viejo. Ms. Brown, Members of the California Debt Advisory Committee, guests and guest speakers: We're here from Palmia Adult Community to address the Mello-Roos Mission Viejo Community Facilities District #87-3. While most of our comments will be directed toward this district, I'm sure they will also relate to the overall Mello-Roos picture. First, some of the background on the formation of the district and the improvements to be funded under the Mello-Roos bonds.

Mission Viejo was incorporated as a city on March 31, 1988 and consists of approximately 10,000 acres in South Orange County. District #87-3 was formed in February of 1988 on a vote of eight property owners as the only qualified electors within the district. Because the formation commenced prior to the formation of the city, the County Board of Supervisors serves as the legislative body for the district and has authorized a bonded indebtedness of $85 million. Our district consists of approximately 1,946 acres of vacant, unimproved land, or about one-fifth of the total community acreage. Most of the vacant acreage adjoins the eastern and northern boundaries of the city. Other vacant parcels lie within the developed areas of the community. The district will have developed approximately 5,013 single and multi-family dwellings and various commercial and public facilities. The proceeds of the bonds will be used to finance certain roadway improvements included within a regional transportation program known as the Foothills Circulation Phasing Plan and the Foothill Transportation Corridor. This program provides for a system of roads and highways in the foothill area of Orange County and is expected to cost approximately $235 million. With this brief background we will attempt to respond to the questions presented in CDAC's letter of 12/30/91, particularly as they relate to the perception of our district.

What are the concerns regarding the implementation of Mello-Roos taxes in your community? That's the first question. The 87-3 improvements are to support a regional roadway system. While the entire community should support this system as they will certainly benefit from its improvements, it is unfair that only one-fifth of the district property owners are bearing the full cost of these benefits. In this instance, the vote of eight property owners placed an entire community's tax obligation on the shoulders of 5,013 homeowners and a few commercial enterprises.

Question No. 2: Are there specific projects in your community that have been financed by Mello-Roos bonds which you believe were not legally authorized? If so, what are the projects?

We believe some of the roadways and improvements have been developed prior to the establishment of a district, yet the projects were designated to be funded by 87-3 proceeds. Just to mention a few, it's Santa Margarita Roadway, Melinda Road and Felipe Road.

If the unissued Mello-Roos bonds--question again--in Palmia were deauthorized, what do you see are the consequences for public services in your community? Do you believe there are other forms of financing which are available to support public improvements which are possibly fairer than Mello-Roos?

We should clarify that Palmia is a single development within the district, and the bonds affect us as homeowners in the district. At this time, it appears that the unissued bonds, $33 million, will not need to be issued. The $52 million issued to date are reported to complete listed improvements, therefore, this deauthorization will have little effect on the community. However, we feel that such major arterial highways and roads connecting the Foothill Transportation Corridor should more properly be the responsibility of the county, state, or federal government instead of a few overburdened taxpayers.

The last question: What specific changes in Mello-Roos Act would you like to see undertaken? We agree with many of the proposed guidelines set forth in CDAC's report. We agree with the recommendation to establish review committees to scrutinize and assess developer applications, but our concerns are more with the fairness of the burden to the ultimate property owner than with the financial security of the bonds. Item B: We agree it is appropriate to set the maximum special taxes at one percent of the anticipated fair market value limiting the total tax burden on the residential property of two percent. We also agree with the recommendation to limit the annual increases and the maximum special tax rate of two percent instead of 3.5 percent each additional year. We agree it is necessary to present homeowners with more detailed information regarding these special taxes. For instance, the annual percentage increases, the number of years a special tax will be assessed, and the fact that homeowners will be the first to pay additional amounts in the event of bond deficiency or default. Now, we know we can't make Mello-Roos disappear. However, when a bill is passed in the California Legislature, it should be enacted with fairness to all and we don't feel that Mello-Roos does that.

Thank you very much.

Brown: Thank you very much. Are there questions from the Commission? Let's also recognize Senator Marian Bergeson who just arrived. Welcome, we're really happy that you're here. Would you like to make any comments Senator Bergeson?

Bergeson: First, I'd like to thank Treasurer Brown and members of the Commission. I think it's very important that this opportunity be given, particularly in an area that we have seen the extensive use of Mello-Roos. I'm also here today because any legislation dealing with Mello-Roos comes through my Senate Local Government Committee. I think that despite the problems, we have seen, certainly, evidence that Mello-Roos does work and builds schools and infrastructure and builds communities for the people to enjoy. It's a sound mechanism to fund the construction of local infrastructure. And voters who support Mello-Roos special taxes do so knowing that their dollars are going to fund specific local improvements. Dozens of new elementary schools in local neighborhoods are in existence today simply because voters knew the project; they knew the costs and were willing to assume that. In Orange County the school districts in Los Alamitos, Costa Mesa, Trabuco Highlands issued $31.6 million worth of bonds backed by Mello-Roos special taxes in 1991 alone. The bonds will help construct school buildings to house children whom the districts would otherwise be unable to facilitate. These district bonds are sound issues with secure and predictable revenue streams. The homes are sold; the homeowners recognize the needs for the schools; and they see their tax dollars at work in their neighborhoods.

As we know, not all Mello-Roos districts are so popular. Too many developers perhaps create new districts backed by unsecured revenue sources. I believe that it's completely unacceptable for developers to form new Mello-Roos districts and issue bonds in areas where inflated property values and unsold homes can lead to taxpayer bailouts of developer blunders. Local officials who approve the formations of the districts may deserve scrutiny, too, and I say that as a former local official myself. And that's why I think we really need to rein in the trust side of the Mello-Roos equation.

I would also like to commend again the staff of CDAC--and the report I found to be excellent. I hope that if many of you have not had the opportunity, that you take advantage. It's one of the best reports on the Mello-Roos that I have seen. The suggestions are good ones. I think we should seriously consider them, and so, again, thank you very much for the opportunity. I'm going to enjoy listening and returning to the

Legislature, hopefully to enact the wishes that the people of California feel are in the best interest of our communities.

Brown: Thank you very much, Senator. And thank you Mr. Hueck.

Hueck: Did you have some questions?

Brown: I did. I wanted to see if any of the Commission members had questions following your presentation.

Hueck: I would like to have Ms. Pat Mosler with me. She's the one who did the research on this.

Brown: Okay, fine. If you just would both come to the microphone and let me ask other Commission members whether they have any questions of Mr. Hueck. I would then have just two short questions. First, when you purchased your property, were you aware of the Mello-Roos special tax?

Mosler: Yes, it was given to me that there was a Mello-Roos tax. I didn't understand the implications of it. I think your statement in your report which implied that the homeowner was involved in buying his home and so excited about everything, so that they didn't really understand all of the implications of the tax, except that there was one. I did not understand that it would increase 3.5 percent per year as a given. I understood that it possibly could increase 3.5 percent. I also did not know, and did not find out until this Monday, how long I would be paying this tax.

Brown: So the amount of the tax and the length of time that it would be imposed and the nature of the increase was not something that you...

Mosler: The initial amount of the 88-89 tax was given to me, but it didn't imply that it would go up 3.5 percent in 89-90, 90-91, and 91-92.

Brown: Very good. And one last question. Given your...I think the main thrust, if I understood it, of your comments was fairness--tax fairness. That you felt you were being asked to pay for the development of infrastructure that benefitted the broader community. Would you be supportive of a constitutional amendment that would bring back majority rule to make infrastructure financing for schools or other infrastructure back to a simple majority?

Mosler: In this particular instance, I felt that the improvements that were imposed on 87-3 were of a broader regional nature, even broader beyond the community of Mission Viejo. Therefore, the immediate benefits did not accrue to those of us who were paying. They weren't neighborhood benefits; they weren't local community benefits. So in that instance, I think that probably some other sort of county and roadway funding should have been implemented. To school districts I wouldn't object to a Mello-Roos being within a district where my children or children were to be going.

Brown: So you would support majority rule or you would not for infrastructure and school financing?

Mosler: I would probably support a majority rule, yes.

Brown: I'm just trying to get at "what do we do." How do we make it fair and not just pass the buck?

Mosler: It indeed is a puzzlement.

Brown: Thank you. Our next speaker is John Beckley from Aliso Viejo.

Beckley: Ladies and gentlemen, Chairwoman Brown, members of the Commission. I am John Beckley. I am from Aliso Viejo. I'm a taxpayer and resident of Aliso Viejo. As such, I live within two CFDs. The first CFD covers schools; the second CFD covers Aliso Viejo infrastructure. Most of my comments here today will be directed to this CFD, known as CFD #88-1, and to Mello-Roos CFDs in general. CFD #88-1 is authorized to issue up to $270 million in bonds for Aliso Viejo's infrastructure. The cost estimates for the works paid by this CFD include approximately $50 million for the San Joaquin Tollway; another $50 million for the arterial highways; only approximately $2 million for public facilities such as gas mains and electricity backbone; and only $8 million for a fire station, a sheriff substation, and a library. In 1988, Orange County and the developer, the Mission Viejo Company, entered into an original developer agreement, whereby in return for developing the area of Aliso Viejo, Mission Viejo Company in turn would provide $68 million in fees towards the San Joaquin Tollway or provide work in kind.

In late 1991, after many Aliso Viejo taxpayers had moved into the district, they entered into an amendment to this agreement whereby $34 million of the $68 million previously mentioned would be forgiven and would be passed on to the taxpayers within Aliso Viejo's CFD #88-1. In turn, that $34 million would be given to the San Joaquin Tollway Agency.

This amendment has not yet been finalized; but if it is, it will have serious ramifications for the taxpayers within CFD #88-1. First, it has resulted in the cost estimates for the tollway being financed by this CFD be increased to approximately $85 million, approximately one-third of the bond issue amount. It will likely result in a diversion of funds from other planned improvements within the CFD. It will likely result in Aliso Viejo taxpayers being forced to forego other planned improvements such as libraries and police substations which they get a direct benefit from or result in a less desirable or lower quality project than previously planned. If this amendment is finalized, it will encourage Orange County and the developer, Mission Viejo Company, to enter into future amendments to the original developer agreement to decrease the amount going into the tollway. Right now, there is nothing in the Mello-Roos Act or in the CFD #88-1 to prevent the County and Mission Viejo Company from using the entire $270 million that have been issued and authorized by CFD #88-1 for the tollway.. This amendment will also result in a change in taxpayer expectations regarding what portion of their taxes would be going to certain improvements including the tollway *after* they moved in, most of them two to three years ago before this amendment. To prevent these local abuses of the Mello-Roos and ensure more protection for Mello-Roos taxpayers, I make the following recommendations to strengthen and improve the Mello-Roos Act:

Number one, there should be a state review committee to review all applications from developers for CFD Mello-Roos taxes, and all CFDs should be reviewed yearly by a state committee to prevent abuse and to make sure they are financially stable. A state committee makes more sense and is more prudent than a local committee as they are more likely to be removed from the local scene; they are more likely to be independent; they're less likely to be susceptible to local developer and local politician influence. A state committee also makes sense as it ensures uniformity and Mello-Roos scrutiny throughout the state.

I also recommend that all major changes such as the $34 million amendment, after a certain number of voters have moved in, be put to the voters, to a majority vote within the district, or at least be subject to state committee review.

I also recommend changes to the current petition process which is now in the Mello-Roos Act. As it now stands, a petition signed by 100 percent of the Mello-Roos taxpayers within that district can be defeated, right off the bat, by a landowner with just 50 percent of the land within that district.

I recommend again that any petition for the changes of the facilities within that district should be up to a majority of the vote of the registered voters within that district. I also recommend that the Act forbid taxpayers being forced to pay for revenue-generating facilities such as a tollway. This is forcing taxpayers to pay something that probably is going to be self-supporting anyway, whether they use it or not. This also promotes inequities as people who live outside the district only pay for it once--and that's when they use it. In any event, if residents are obligated to pay for such a revenue-generating facility, such as the tollway, they should be given a credit or a waiver of the toll or fee when they use it to prevent multiple taxation.

Finally, all local agencies that receive Mello-Roos funds, such as water districts, school districts and transportation agencies, should have at least one taxpayer from each CFD that is contributing substantial monies to that agency. To do otherwise results in a taxpayer having no say in how their money is spent, and other residents who do not live within that CFD telling those taxpayers how that money is going to be spent. This is the current situation now in Aliso Viejo. For example, the San Joaquin Tollway Agency is composed of residents from the surrounding communities of Laguna Nigel, Newport Beach, San Juan Capistrano, Mission Viejo, Dana Point, and San Clemente. None of these communities that surround Aliso Viejo and that surround the tollway--and get a direct benefit from the tollway--are contributing one cent toward the San Joaquin Tollway. However, these residents get a say on how the Aliso Viejo Tollway money is spent.

I thank you.

Brown: Thank you very much. Are there questions from the Commission members for our speaker? Very good. Thank you for your thoughtful suggestions as well. We will take note of those and consider them. I think we now have Robert Beaulieu. Is Mr. Beaulieu here? From Tracy.

Beaulieu: I'll just wait a minute so that you can receive your copies and can read along with me. You'll have to excuse my voice; I'm recovering from the current flu...Treasurer Brown, members of the panel, we'd like to thank you for the opportunity to present our concerns over the Mello-Roos funding in Tracy, California.

We believe the implementation of the Mello-Roos Act in Tracy has been a fraud. Under the guise of using this funding mechanism for new growth, the City of Tracy and its administrators have subsidized the funding for projects like schools, transportation facilities, busing costs which all serve the entire community. A master plan is being carried out in which the taxpayers in the Mello-Roos districts are paying for facilities which are the responsibility of the entire community. Along with this plan, the Tracy City officials have gerrymandered the school districts in order to service these older areas as well. For one example, Mello-Roos taxpayers are financing a $26 million high school. Currently, 40 percent of its population will be non-Mello-Roos children. The present gerrymandering often displaces children of Mello-Roos households because the new schools are filled with non-Mello-Roos students as soon as they are open. The children of the Mello-Roos taxpayers are then sent from their new neighborhoods to the old schools outside the Mello-Roos districts. The Mello-Roos taxpayers have no guarantee they will benefit from their special tax dollars. We believe this is in direct conflict with one of the basic principles of the Mello-Roos Act--that all property owners in the CFD must benefit from improvements. This is clearly not happening in Tracy.

Also built into the Mello-Roos funding vehicle is a very nice loophole for select landowners in Tracy. They may build up to four homes a year within the CFD which are exempt from the Mello-Roos tax. For example, the city council member Richard Pombal's family has used this loophole by developing homes for resale inside the CFD. Cunningly, these homes sit in the middle of two subdivisions paying Mello-Roos, but his homes are exempt from the tax.

The governing board of the Mello-Roos funds, called the Tracy Area Public Facilities Financing Agency (TAPFFA), is appointed, not elected, comprising members from local school boards and the Tracy City Council. Not one member of this board represents the Mello-Roos taxpayer. To us, this is like a thief with a stolen checkbook and an unlimited supply of funds.

Also implemented in the Tracy CFD is authorization to increase taxes by two percent a year with no cap. Currently, the yearly amount for each single family resident is $1,048. The response of our local representatives regarding the wishes of the Mello-Roos taxpayer has been one of contempt. All requests have been disregarded. Finally, in desperation, a coalition was formed to tackle the resistance from this abbreviated TAPFFA Board. Our coalition presented a petition signed by the CFD resident. It asked for an immediate freeze on any new bonds for the district by way of a ballot election. The governing board is allowing an election but has changed our petition, negating its effect by adding that alternative funding must be found by members of the CFD before a freeze can take effect.

During the course of the implementation of Mello-Roos in Tracy, we homeowners have watched the value of our homes decrease. New home buyers see that they can buy a home outside the CFD and can still benefit from the use of Mello-Roos schools and facilities without ever paying the tax. Realtors promote homes outside the CFD as a better investment. The sale of homes in the CFD suffer tremendously. Conversely, buyers in the CFD were originally told their extra tax dollars would go to create more desirable neighborhoods and therefore increase the value. As homeowner and taxpayers, we believe the establishment of a Mello-Roos CFD should only be the result of an election by homeowners instead of one done in the shadows in which developers and landowners shirk their responsibilities onto future home buyers. We believe only Mello-Roos money can be used in Mello-Roos CFDs--not to carry the burden for an entire community.

Also, the Mello-Roos Act is not a necessary tool for financing developing areas. We believe there are other options. Among them, developer financing, use of sales taxes, state and local government resources, and as another option, year-round schools. At the present time, action is desperately needed by the state to stop the injustices to homeowners by city officials and developers. Mello-Roos taxpayers need an agency to oversee, audit, and direct existing Mello-Roos CFDs. Finally, the ultimate authority in any CFD should be the Mello-Roos taxpayer.

Thank you very much.

Brown: Thank you. Let's see if we have some questions from the Commission members.

Burton: I have a couple. To clarify your point about the members of your Mello-Roos board not being elected, they represent city council members who are elected, aren't they?

Beaulieu: Yes, they are. They're city council members and board members which are elected. Basically most of them, I believe, prior to most of the new homeowners moving in... They're not elected to this Tracy Area Public Facilities Financing Agency. They're appointed, and it's kind of a rotating door. They take turns for a one-year length of time.

Burton: Okay, but they are elected for the originating bodies that they sit on.

Beaulieu: They are elected officials for the City of Tracy for school board and city council.

Burton: Do the taxpayer in your Mello-Roos district have an opportunity to vote for these people who sit on the school board.

Beaulieu: In upcoming general elections, yes. We will have an opportunity to vote on some of the positions. But we have no representation for us at this point in time.

Burton: But you think that these representatives should be separately elected to represent the taxpayers in the Mello-Roos district? Is that the point you were making?

Beaulieu: Yes, the main point I want to make is that we have no representation at all. There should be a better establishment to provide representation for the Mello-Roos taxpayer. At this point in time we feel there is no representation.

Burton: Okay. You also make reference...since I'm from the Department of Finance, and I know that we don't have any money either...you quickly went over the other options...I wanted to delve into those a little bit more because you make some really cogent points. But we're looking for options, and the first option that you mentioned was the developer financing; the second was sales tax...

Beaulieu: I can give you an example. Developer financing: we believe a greater percentage of fees to be paid to promote or pay for some of the facilities should be the responsibility of the developers instead of more of it being passed on to the taxpayer. Recently, in the city of San Francisco I believe a quarter cent sales tax was voted into law to help supplement the school system there.

Brown: Which is now subject to review by the California Supreme Court because of a Supreme Court decision dealing with what's called the "Rider" case, and the possibility that a majority vote was inappropriate and unconstitutional in terms of Prop. 13.

Brown: Do the other families with students that attend the schools within the Mello-Roos districts--do those families pay taxes at all that are contributed to the building of those schools? Or are the schools in the Mello-Roos district financed solely by the Mello-Roos taxpayer?

Beaulieu: In most cases, they are solely financed. Now, the TAPFFA Board, this Tracy Area Public Facilities Financing Agency, has taken some of the Mello-Roos funds to help in non-Mello-Roos schools also, which is outside the CFD, which is in question also. We feel it's just a totally abusive setup that we have now in Tracy.

Brown: Currently, state G.O. bonds to finance school facilities can be passed with a majority vote. There is, in turn, no revenue that is generated by that approval of the state G.O. bond to finance schools. That money has to come out of the general fund which as Ms. Burton knows is sorely stressed right now and will continue to be sorely stressed at a time in which California is looking, in terms of education, at 200,000 new school kids a year. And, boy, in Tracy and Manteca and Ceres and Modesto, and all throughout the Valley, you're feeling it just like they are in Orange County and Riverside and San Bernardino. So my question that I asked to the first speaker, given this fairness issue and given this equity issue, would you consider putting the local tax for schools, for example, which now requires a two-thirds vote, which has forced the creation of these alternative financing strategies, like Mello-Roos--would you consider that it would be fair and more appropriate to finance these facilities with a majority vote of all of the citizens of that community as opposed to requiring a two-thirds vote which is not majority rule?

Beaulieu: Yes, we would be in favor of that.

Brown: Okay. There is something currently in the Legislature...the governor has supported it; the Legislature supports it--ACA 6 which (and the Senate supports it as well, not the Assembly)...

Burton: Yes, that's true. It's been stymied in one of the committees there for some time. And there's a question about whether it can garner sufficient support because it's now being viewed as it's too easy to tax people with a majority vote.

Brown: So I just put that out there. We're hearing from taxpayers. They are raising, you are raising, very legitimate concerns. In the alternative, the state is growing. It's going to continue to grow. We can't limit that; we can plan for it. To plan for it, your public policymakers, your elected officials need to have tools that will work so that we can be fair. And that's why I raise this other option and ask you to consider that--and it's stymied and caught up in the processes of government; it's not enjoyed the kind of enthusiastic support that it's going to need to move forward to give you the opportunity to just vote on it as an option.

Beaulieu: If I may make one more comment. When we first were getting together with our coalition, we looked for one certain agency or one place that we felt would have to watch over these Mello-Roos CFDs, and we were told there isn't really one body that does that. And I think that that has given an unfair license to local communities to do what they're doing to us.

Brown: That is why we're having this hearing today. And that is why we appreciate all the input.

Beaulieu: I'm sorry but I cannot stress enough the urgency to create a body to do just that.

Brown: We appreciate very much your coming the long distance here today to share with us your concerns. I know there are other representatives in the community. We just want you to know that there is this larger problem of how we manage to do the job that is the most basic job of government--which is to educate and provide transportation and these public facilities. But we hear you, I think, quite clearly. Thank you so much.

Beaulieu: Thank you very much.

Brown: Next is Julie Gordon also from Tracy. That's right, he's (Mr. Beaulieu) spoken for you. Next, we'll turn to the public agency perspective, and Eileen Walsh from County of Orange. Ms. Walsh, we want to thank you for your hospitality today. You have very nice quarters.

Walsh: Thank you. I might at this point take that opportunity to remind people standing in the aisles that there are seats here, or the Fire Marshall will come in and ask us to clear the aisles.

Good morning, Ms. Brown, Honorable Senator Bergeson, and the CDAC members. We have five questions this morning that we have been asked to respond to, and I'll go through them in the order they were asked.

1. What are the county's objectives in the implementation of Mello-Roos?

   In Orange County, officials have worked in partnership with landowners to attain two objectives: assuring adequate infrastructure to support the orderly development of the South County and achieving tax equity via the benefit principle. During the 1980's, the County developed new planning tools and fee programs in a focused infrastructure planning effort. We monitored local and regional service availability, evaluated the cost of new services, and tied provision of new services to new development.

   The 1980's also saw an increase in public awareness of growth and infrastructure issues--a public concern which led to the qualification of the "Citizen's Sensible Growth and Traffic Control" initiative. This ballot initiative's purpose was to control future growth and to require certain levels of public service.

   Although the voters rejected the measure, the threat of its passage provided serious motivation to developers of large land holdings to negotiate development agreements with the County. In August of 1988, the Board of Supervisors adopted a resolution approving a growth management element of the county's general plan which, in the spirit of the initiative, required adequate infrastructure and public facilities concurrent with growth. As a result, the County entered into development agreements with most of the major landowners in the unincorporated areas. These development agreements quantify and set timelines for needed facilities. The agreements call for early construction of fire stations, libraries and arterial highways funded by developer contributions and by debt placed on their landholdings.

   The County wants to emphasize that the development agreements extracted public benefits which went well beyond those required of developers under the California Government Code. The County uses its authority to issue tax exempt bonds in support of regional projects. The public purpose served by both creation of the district and issuance of debt is the early opening of public roads and services to this growing region. Exactions on a smaller scale, those customarily viewed as the developer's responsibility in new tracks, are not typically included in bond-funded programs.

   Creation of community facility districts offered a win-win solution to the conflict among those in the community who, on the one hand, saw growth as essential to the continuing prosperity of the County and, on the other, wanted assurance that quality of life and level of service within the County would not be eroded by new growth's challenge to our limited resources.

The Mello-Roos Act provides a local financing mechanism to allow construction of needed facilities, particularly highways and schools, which are not adequately funded by the state. Keep in mind, with respects to the property tax, Orange County is a donor county receiving only 18 cents for every dollar of assessed property tax. The statewide average for counties is 33 cents.

In Orange County the use of community facilities districts is not a fragmented developer-driven, hit-or-miss affair. It is a planned program of orderly phased growth in which the county and a group of committed forward-thinking landowners are full partners to attain shared objectives. We believe it is the only finance tool which funds public improvements to create self-sufficient, planned communities. It does this without spreading the tax burden for growth-related improvements to older established neighborhoods.

2. What is the role of Mello-Roos in congestion management?

We often refer to Orange County's Mello-Roos districts as our "roads first" program. Our primary intent is to assure an adequate network of streets and arterial highways to keep the cars of the new South County residents from clogging the near capacity roads and freeways of the region. One important goal of the Mello-Roos program is to generate more than $210 million for the development of an interlinking network of 40 road projects known as the Foothill Circulation Phasing Plan which makes South County accessible to workers, businesses and residents. We have used the level of service standard in determining needs and tax level impacts to avoid further congestion.

3. Can Mello-Roos result in some taxpayers subsidizing a larger community?

Mello-Roos, as nearly all other available taxing strategies, places disparate burden on taxpayers. Living as we have with the effects of Proposition 13 and declining federal and state assistance for infrastructure for the last decade, we're well aware that Prop. 13 shifts a greater burden to the community's newcomers and to those who changed residency since its enactment. One of the messages taxpayers sent to the government through Prop. 13 was that the general taxpayer was no longer willing to pay for new communities, new schools or new roads that were not of direct local benefit to them. The businesses and homeowners in our developing South County bear the costs of the new infrastructure. They do this either through developer fees added to their purchase price or through a special tax levied on their property for 20 or 30 years. Others will drive on the roads they have paid for. Future generations will use the libraries they have built. Had more equitable strategies been available, we would have preferred them. Our options were few and the needs are great. Mello-Roos became the best available solution to permit the County to grow economically.

4. What are the consequences to service levels if unissued bonds were deauthorized?

We are presently just past the halfway point in the issuance of debt needed to support the full construction of the Foothill Circulation Phasing Plan. If we could no longer issue bonds authorized under the existing districts, the development of roads would be slowed, but it would continue in the future as sufficient developer fees trickle in to permit the County to enter into construction contracts. As noted above, these fees are passed on to new homeowners and businesses. The delay could result in a patchwork of unconnected road fragments awaiting buildout segments in the future. Some pockets of development might remain reachable only by narrow or overcrowded roads. Businesses could quite likely relocate to regions better served by public infrastructure.

5. State and local actions needed to protect taxpayers and investors:

We feel that Orange County's guidelines for the issue of Mello-Roos debt developed over the past several years can serve as a model for other issuers. We would gladly work with your office and share the eight features that are central criteria to our guidelines.

1) A clear identification of the public purpose and regional impact of facilities to be funded. We think that's first and foremost the most important element of a good Mello-Roos program.

2) Taxes are related to the benefit, the use, and the cost of facilities. Identified ceilings exist for the taxes for prospective purchasers on their property. These maximum taxes must be disclosed by the developer or merchant builder before a sale is complete.

3) We issue no debt without a review of the developer's history in obtaining and paying on other loans as an indicator of their financial ability to pay their taxes on undeveloped land within the district.

4) We issue no debt without retention of an independent economist and a review appraiser. The economist projects probable land absorption rates based on very conservative projections regarding the local economy. These projections are used by the appraiser in assessing land value. The review appraisers are hired by the county and use our appraisal guidelines to assure the valuation of property are based on its present condition and on a worst case scenario of value in a bulk sale.

5) We issue no debt unless the land value is at least triple the debt on a district, and coverage under a district's rate and method of taxation must well exceed the maximum debt service payment a property could sustain in any year. If any one large parcel or tract within an otherwise sound district fails to meet this two-fold test, additional surety is required to assure that the district can sustain its obligations, not only in the aggregate, but tract by tract. Our intention is to preclude one payer's default from adding to the burden of his neighbor's. We analyze overlapping debt in this formula, as well.

6) We review tax delinquencies regularly on the districts as a whole, and as needed, of builders within a district, as well. We intend, if it is ever necessary, to aggressively pursue foreclosure proceedings against any tax delinquent developer.

7) We are diligent in disclosure to prospective bond buyers about the nature of the district: who the developers are; what environmental considerations may exist, such as water availability or endangered species; and how the district is able to sustain proposed debt.

8) We are careful to invest proceeds with highly rated investment providers.

In sum, we believe there are two factors to a successful Mello-Roos program: (a) that homeowners and businesses know clearly what their maximum tax obligation can be, and what they will receive for their taxes, and (b) that bond holders understand the nature, as well as the potential risks of these securities.

We thank you for conducting this hearing. And we welcome the State Treasurer's Mello-Roos guidelines dated September 19, 1991. We're confident that Orange County-issued Mello-Roos debt meets or exceeds all of the standards in that document.

And I have written copy of testimony.

Brown: Thank you very much, Ms. Walsh. Yes, Senator Bergeson.

Bergeson: I'd like to ask a question that was brought up by one of the earlier speakers, and that is regarding amendments to Mello-Roos. How is that handled? How is notification handled and how does that deal with the original agreement by the homeowner at the time of purchase?

Walsh: There have been no amendments executed which affect the maximum tax on residents. I think the amendment that was referenced is an amendment that has also not been executed relating to the amount of money the CFD in Aliso Viejo will contribute towards the construction of the San Joaquin Hills Corridor. There is no project in any of our CFDs which was not disclosed in the initial district engineer's report. That's part of the formation process. And I think when the attorneys speak later on the legal perspective they can answer any technical questions about amending the original district engineer's report. It's my understanding--and we have never done that--that should we want to include a project that was not included and discloseable at the time homeowners moved in, it would take a two-thirds approval of the residents in that CFD.

Brown: Thank you. Other questions? I do have one last question and it relates again to the earlier speaker's comments, and it relates to the benefit basis. How can you justify the decision on the benefit basis--and I'm just trying to understand what benefits do accrue--when persons just outside the CFD will benefit from the tollway just as much as those inside. What is that benefit analysis?

Walsh: The benefit analysis is done by an engineering firm. It's not something that pulled out of blue smoke and mirrors. It's done in a similar fashion to the rules that follow an assessment district. We do have a benefit analysis done by the engineering firms to determine the tax benefit to residents. On a larger issue about whether the toll road benefits only the residents in a particular CFD or the larger, I think it would be fair to make the factual correction that there are lots of additional funds from the surrounding communities that are being put into the San Joaquin Hills Corridor. It is not being funded out of one CFD.

Brown: It is not being funded out of one CFD; it's being funded out of...?

Walsh: Out of all the communities to which it benefits. The benefit assessment, if you will look at it from our perspective that we took early on when I tried to lay out the philosophical underpinnings by which this County undertook Mello-Roos financing, is that we did not want to spread the burden for South County growth to the existing North County homeowners.

Brown: Is it possible that it could be disproportionate on one CFD, such as Aliso Viejo?

Walsh: The reason I'm hesitating to answer... As you may know, we have three or four taxpayer lawsuits on the Aliso Viejo/San Joaquin issue, and I'm looking toward County Counsel because this is not the arena in which to discuss issues if I'm not to discuss them. So I kind of need a head nod of whether or not to answer that. Seeing none, I suppose the litigation prevents us from really getting into a thorough discussion of that right here. There are some factual pieces of information in one of the earlier testimonies that probably could be corrected.

Brown: Okay. Very good. Thank you for your testimony and your responsiveness. Next is Timothy Davis, County of Riverside. And I know we asked five questions. If you think you can answer the five questions in shorter terms we would be appreciative. We have a very lengthy agenda. So we welcome you and appreciate your comments, Mr. Davis.

Davis: Thank you. The written statement addresses all five of the questions that you have posed. I've also attached to that as exhibits a listing of all the community facilities districts which the County of Riverside has formed. And attached secondly is the policy procedures with regard to our forming of any of the assessments...

Brown: Could you just state your name and who you represent for the record.

Davis: Timothy J. Davis, Deputy County Counsel with the County of Riverside.

And attached as Exhibit 2 are the adopted rules and procedures of the County of Riverside with regard to the formation of any district, the structuring of the rate method, apportionment of the tax, as well as various guidelines with regard to the actual structuring of the bond transaction itself.

Now, I'm not going to get into those in any great detail, and I'm not going to go through all five questions. I wanted, and I've taken three pages in my written statement, to focus on one of the issues which has come up through all of the testimony so far this morning. And that is: how does one go about approaching in a CFD, which primarily is directed towards constructing regional facilities, an equitable balance between the obligation of homeowners that eventually will live, or the businesses that are located within the district, when the facility will necessarily, as a regional facility, benefit persons and businesses outside of the boundaries? And this has bothered me since I started in this about six years ago. And the County of Riverside approaches these things from the perspective that we are the only existing advocate for the homeowner at the time these things are formed. And if we can't justify them to ourselves, we're not going to be able to justify them to the homeowners five years from now when they're knocking on our door and ringing our phones, "How could you have done this to us?" So consequently, when we have gone out to construct the major thoroughfares, the freeway interchanges, the overpasses, the trunk sewer mains, the waste treatment plants, and so on, we have approached all of the other public entities that we have to deal with that, in fact, we are building something that you *need*. But other people are going to benefit from it so you have to, in the joint financing agreements, contribute your fair share toward those facilities. Now, I've gone into examples in my written testimony as to how that can occur, and I'm going to briefly over the two examples that I've given.

With regard to a large thoroughfare or even an interchange, the County has started to utilize road and bridge benefit districts which are allowed under the Government Code. They include a rather substantial area, and the CFD may be a small portion of that road and bridge benefit district. The CFD may build two or three of the ten facilities that this road and bridge benefit district is going to build. And the road and bridge benefit district is seen as a pay-as-you-go type of mechanism, where it sets a fee every time a building permit is pulled that will go toward the construction of all ten items. But the CFD can accelerate that pay-as-you-go because it's going to front end two or three facilities. So consequently, what we do is that we: (1) All fees that have been collected to date that can be attributed to those two or three facilities are then pooled over into the CFD monies to lower the amount of principle bonds that are initially sold. Those then are contributed toward the actual construction. (2) With regard to all of the developers and all the homeowners and property owners, we say you get a dollar-for-dollar credit against your road and bridge benefit district fees for every dollar that you actually utilize from bond proceeds to construct these facilities. So that in many instances we can wipe out the road and bridge benefit district fee altogether. And finally, we say we're going to have this road and bridge benefit district in place for 20, 25, 30 years. All fees collected in the next 20-25 years that can be attributed to these two facilities are paid back into your debt service fund, and we go out and redeem bonds. And so consequently, the property owners within the district do not pay on the analysis of both the road and bridge benefit district, as well as the community facilities district, one more dollar than the entire region is going to get out of the benefit of these regional facilities.

Now that's real easy to do when you're running the whole show because the board runs both the road and bridge benefit district and the CFD, so you don't get into flack there. But let's go to the water districts. We have built lots of trunk mains and sewer treatment plants, and so on and so forth. And in those instances, we go in with the same attitude with regard to the water facilities as part of the joint financing agreement which we're obligated to negotiate. I make sure that for those facilities which are regional facilities, those water districts collect connection fees. And out of those connection fees there is a capital facilities component. It may not be labeled as such but they have them. And out of that capital facilities portion of the connection fee there are dollars. It may be only 50 cents; it may be $1.50 that is to go toward those very same facilities that the CFD is accelerating the construction of. And I get out of each of the water districts a commitment that for that portion of the connection fee that would otherwise have been directed toward the facilities that the CFD is constructing, those monies will be paid back over again to the CFD for the purposes of redeeming bonds and taking down the debt obligation on these people. In addition to that we also go back and negotiate that these people also get the same credits toward connection fees and other fees charged by the water and sewer districts in relationship to the facilities that they're putting in. So that there is a real active position on the County of Riverside to deal with these regional facilities and not to overpay or cause these people to pay twice.

In addition, when we go to look at the various other fee programs of the County of Riverside we make sure that the facilities that we're constructing through the Mello-Roos program are not facilities that we're also collecting developer fees for, traffic and signal mitigation fees for, and so on; so that the person that buys that home is not going to be paying twice for essentially the same facility. And that is a very important position of the County of Riverside. We feel that we have to advocate for the homeowner because he isn't there to do it for himself. And we are not going to have him double taxed or pay twice for the same facility; and to the best extent possible, they are not going to pay a disproportionately large amount for that particular facility.

Now, with regard to the last question that you pose. The rules and regulations of the county on these districts goes on for five or six pages with addendum on top of that. I want to augment a little bit on what Eileen earlier testified to. With regard to the County of Riverside, the land-to-lien ratio before we'll go out to debt is 4:1. We will not sell bonds unless there is a 4:1 land-to-lien ratio. We structure our taxes so that the tax ultimately, including the special tax when coupled with ad valorem and all other overlapping debt on that property, does not exceed two percent of the anticipated assessed valuation of the property. Now, in my written comments I've indicated to you it's becoming more evident to the County that if we're not building everything infrastructure-wise with regard to a particular CFD, we've got to bring that two percent overlap down even further to let's say 1.75 percent or 1.50 percent to accommodate for schools or other people or other entities that will be taxing or using other mechanisms. And it may not be CFDs; it could be assessment districts; it could be general obligation bonds; it could be any one of a number of things. The goal is to try and keep the ultimate debt obligation on any parcel within a CFD, or an assessment district for that matter, not greater than two percent as far as its assessed valuation is concerned.

Another thing that I want you to understand with regard to something that's unique in Riverside County that we don't do any place else--and also deals with this fact of whether or not the developer of the vacant property is paying less than it should--is that in the County of Riverside, at the time that we close any community facilities district, we require any property owner who is responsible for more than 33 percent of the special tax obligation associated with the bond to post a letter of credit. That letter of credit is a one-year letter of credit equal to two times the debt service for the special tax obligation on his property annually renewable. If it isn't renewed we hit that letter of credit and put the money into an escrow account. That letter of credit will be reduced over time until that property owner's liability is less than 33 percent. We feel that coupling that initial letter of credit with the reserve funds that we establish with regard to all of these transactions provides the County of Riverside with at least 3.5 to 4 years of cash flow with regard to that district which would be more than sufficient time to get us through a complicated foreclosure and bankruptcy situation so that we could exercise our rights with regard to that property. Now that is relatively unique. We're the only entity that I know that does it, and we don't advertise it in our official statements. We do that simply for the self-serving purposes of having a cash flow and not having the bonds bearing our names go belly up.

Brown: Thank you. Are there questions from the Commission members. Yes, Senator Bergeson.

Bergeson: I'm not at all certain that it's even appropriate to bring it up. But perhaps you could give me some idea on how the response to the Temecula School District Mello-Roos situation... what the prognosis and how this might impact since the concern, of course, of foreclosure is always a very real concern; and if there has been some thinking as to how that result might take place?

Davis: That particular issue the County of Riverside had nothing to do with. Neither the issue, nor do we have any joint financing agreements with the entity, and so anything that I might say on that is perfectly hearsay. It's only what I've read in the papers or have heard form other individuals. And so I don't feel comfortable responding to that one at all.

Brown: I'd just like to ask one question about the letter of credit notion. Is there a problem with the letter of credit today in attaining it, given the credit crunch in the marketplace? I know with the industrial development bonds that we finance through the state we lost $29 million in viable applications because of the inability to get a letter of credit. Or does it add an undo additional cost to the property owner because of that letter of credit.

Davis: Interesting you should bring that up. Yes, and we have solved that problem. Okay. We require a letter of credit from the developer and have from 1986 to date. In the last year we discovered that in many instances the banks were not willing to give the letter of credit that we required from the developer. We still require the letter of credit with regard to residential CFDs. We will not shift the burden because they are not of the great priority to us that the commercial/industrial CFD is.

With regard to the commercial CFD, we have now come up with a very unique document. We have a surety company that will issue a surety bond. And we have a companion surety agreement. Now it took us a couple of months to draft this document up, but we have a surety bond with a companion surety agreement that read *exactly* like our letter of credit. And we consider the cost of this and the purpose of this to be related to the administrative responsibilities of the district so we take it out of the administrative costs of the district and the CFD actually pays the points associated with the surety bond. And the bonds generally cost us two points for the face value of the bond. So that if it's a $4 million dollar bond it cost us about $80,000 a year. And we increase the special tax as part of our administrative expenses to cover that. It goes down essentially if it is still principally the sole property owner. He's paying that through his tax. But we still have the liquidity objective that we had intended with the letter of credit, only the CFD is paying for it and we have come up with this mechanism.

Brown: Is everybody in the district paying for the surety bond?

Davis: Yes, but invariably what we have here is a large commercial developer who is going to be in that position for a substantial period of time. And so consequently, it's a shopping center; and they're going to be continuing to pay the shopping center and they're not going to diversify ownership. And so consequently, they're paying for it for the entire length of time.

Brown: Very good. Thank you very much, Mr. Davis. Our next speaker is Ray Wood from Lake Elsinore. Mr. Wood...Good morning. Again, I would respectfully ask you to keep your comments as succinct as possible.

Wood: I will attempt to do that. I'm Ray Wood, Special Projects Coordinator for the City of Lake Elsinore. And of course, as you are well aware, we've been the brunt of some rather unfavorable, I think grossly uninformed, publicity through the newspapers. I'm not here to defend that. I'm here primarily to tell you what we are trying to do and try to respond to the questions that you have specifically asked.

I'd like to read the three questions you proposed; but rather than answering them specifically point-by-point, I will answer them in terms of a general discussion. The first question you asked was:

1. What do you see as the opportunities and potential problems with your community's aggressive use of Mello-Roos financing?

2. If your city's growth projections do not materialize, what will be the impact on credit quality of your outstanding Mello-Roos bonds?

3. What actions has your city undertaken to ensure that it does not become over-indebted through the issuance of Mello-Roos bonds or other types of debt?

By way of background, of course, Lake Elsinore is right in the midst of what is acknowledged to be the most rapidly growing area of the state. We have independently developed demographic studies which indicate that our population is now somewhere between 19,000 to 20,000. It was 6,000 six years ago. We'll be in the neighborhood of

75,000 to 100,000 by the turn of the century. Obviously this indicates substantial and rapid growth. We have in various stages of planning by major developers, some 20,000 residential units anticipated over the next ten years within the City. Obviously, we have to have some vehicle for financing the infrastructure that all of this is going to require. We feel, and have felt, that the Mello-Roos Act provides for us an excellent method.

Reference was made a little earlier to developer financing. In today's world that is almost an impossibility. As we know, the commercial area will not give developers financing to put the infrastructure in. We recognize that the infrastructure that is going in is going to be paid for by the property owner ultimately, one way or the other, either through a mortgage or through financing.

The example which was in your report is an excellent example of how in the long run it may cost the property owner less to have CFD financing for his infrastructure than if he has to pay for it through a mortgage. We have made a very detailed analysis of the CDAC report, and item by item in your guidelines. We already had everyone of them in place plus, prior to the time that report came out.

We are making every effort in everything we do to be conservative in the application of the CFDs and the maximum tax. We do have an independent team consisting of independent engineers, attorneys, I being the only City representative on a team that in detail reviews with the developers every project to be accomplished within the City in multiple meetings prior to the time we even consider establishing a CFD. We have three in place right now. None of them have reached the two percent guideline which we are using, or one percent for the CFDs. Everyone of them is under one percent in the total tax burden, considering overlapping debt and other matters, so that we have attempted to be very conservative. Of the three that are in place, all of them have at least 3:1, one of them has 9:1 value-to-lien ratio going in. And we will not, in our case, consider less than a 3:1 value-to-lien ratio.

There have been comments as to the tremendous aggressiveness of our City and the $500 million authorizations and so forth. We have issued to date $38 million worth of Mello-Roos bonds. There are other types of debt that have been issued totaling only $70 million, not $500 million. The $500 million is nothing more than an authorization to be spread over the next 20 or 30 years as it may be needed.

Brown: You've authorized $500 million; you've issued in total $38 million?

Wood: That's in our Marks-Roos pool. And all of our Mello-Rooses are acquired by our Marks-Roos pool, our public financing authority. So that the ultimate public risk is at the Marks-Roos level, which I know your Commission is studying that and going to put out a report on it. But in terms of Mello-Roos, we have only the three outstanding; we have several pending that we anticipate will come to maturity over the next several months. All of these criteria will be met or they will not be issued.

In terms of assuring, as best we can, the values going in, we require an independent MAI appraisal. And "independent" means an appraiser approved and/or selected by the City, not by a developer, so that we overcome the potential that has been expressed of having developers pad their appraisals in order to increase the value of the bonds that might be issued against them. An MAI appraiser is a member indirectly of our team.

We feel that if there is any problems with tax collections that we are covered. First, we do follow the guidelines that you set up requiring at least two years of capitalized interest. We have already ascertained at this point in time whether the developers that have outstanding Mello-Roos have paid their December 10 installments of taxes. Our procedure calls for, the minute we can learn from the County, that any property owner, developer or otherwise has defaulted, we will immediately institute foreclosure proceedings to force the issue. Our bond indentures require that we institute such proceedings within 150 days. Without question, we do not plan to wait any longer than it takes to get the information out of Riverside County as to that.

So we feel, overall, that we have a very strong position. We feel that if there is a default with the ability--and I've already had several calls about this--if it happens, somebody can walk in for a penny or two on the dollar and acquire an already developed area. And all of our CFDs are acquisitions; they are not constructions at this point in time.

Brown: Thank you very much, Mr. Wood. Do we have questions from the Commission members? I just have a few questions because you have been covered widely in the media and I'd like some clarification. First of all, would you say that the current recession and contraction in demand for real estate, as well as some of the problems caused by the draught a year or so ago, poses any threat to the Mello-Roos bonds which have already been issued for development, such as the Tuscany Hills?

Wood: No, as a matter of fact those that have been issued on behalf of developers who are in fact developing today and pulling permits.

Brown: They are developing?

Wood: They are developing, yes. They slowed down obviously, as everybody has with recession. The Tuscany Hills developer has built over 200 homes.

Brown: How many has he sold?

Wood: Over 100.

Brown: Sold 100 out of the 200? Have they closed?

Wood: Yes, and incidentally we know they closed because we designed our own disclosure which discloses all the things about the tax including the tables and everything. And we require an original signed copy of that to be filed with the City before escrow closes.

Brown: Also, with respect to the Tuscany Hills development, it was reported that Lake Elsinore approved $14.1 million of Mello-Roos bonds even though the City was aware that the savings and loan institution, which owned the development firm, was in serious financial trouble and a candidate for seizure by the Resolution Trust Corporation. Was this reported correctly?

Wood: Hardly. Yes, we were aware. We had several meetings with Homestead. But the part that is not revealed in the publicity is that less than 20 percent of that project was Homestead Savings and Loan. The other 80 percent were merchant developers who had acquired the land and are, in fact, today still working. And Homestead did build a lot of homes.

Brown: So the S&L in question owned only 10 percent.

Wood: About 16 percent actually.

Brown: And does the City of Lake Elsinore have the first lien on the Tuscany Hills property?

Wood: The Public Financing Authority owns the Mello-Roos bonds which, in that case, I guess I would say that we have the first lien. But all the developers, including Homestead, have paid their taxes this year so far.

Brown: Finally, there were reports that the consultant fees paid by your city are almost twice that paid in other cities.

Wood: That also is a fallacious report. The overall costs of issuing using the Marks-Roos flexibility is there. It actually is less than it would be if these bonds had been issued on the open market. And we can substantiate that.

Brown: But in comparison to other Mello-Roos districts?

Wood: No, that is simply not a true statement. Our overall costs of issuance have never exceeded about 2.5 to 3 percent for the total cost of issuance.

Brown: But you've authorized $500 million, but you've only sold...?

Wood: $70 million--Marks-Roos. We've authorized $500 million Marks-Roos; we've only sold $70 million of the Marks-Roos. A big part of that went for tax allocation bonds. And there were some assessment districts involved in that as well. The CFD total is about $38 million of that.

Brown: Okay. Very good. Thank you very much, Mr. Wood. Next is David Doomey, Capistrano Unified School District.

Doomey: Thank you. I'm Dave Doomey with the Capistrano Unified School District. The Capistrano Unified School District would like to thank you for this opportunity to present the following material related to the Mello-Roos Act of 1982. Specifically, I would like to address the three questions that were asked of the district:

1. How has Mello-Roos financing benefitted our district?

   The Mello-Roos Act of 1982 has been extremely important as a vehicle to raise local funds to secure land and fund school construction projects in our district. We have a funding program that currently is in place for our current ten approved 50/50 projects. The plan includes combining three types of sources of funds: Mello-Roos bonds proceeds, developer fees, and funds from the State School Building Program.

   The financial plan identifies that we currently have purchased five school sites with Mello-Roos bonds proceeds, and we have also set aside funding for future expenditures for construction and furniture expenses. Of the ten 50/50 state projects, we are currently under construction for a K-6 site in Royal Vista located in Rancho Santa Margarita. And additionally on January 6, 1992, the Board approved a $22 million construction contract four our fourth high school in the district.

2. In the absence of Mello-Roos financing would we be able to provide adequate service levels for our district?

The simple answer to that is "no". The state's school bond measures have provided funding for school districts, but unfortunately it has not been enough to meet all the demands in California. The California Debt Advisory Commission did release an excellent report which has been referenced several times already this morning, titled "The Mello-Roos Financing in California," in which it's implied that the state's construction program is severely underfunded and probably will be for some time. At the current time, Capistrano Unified has state approval for ten new schools that would be under construction at this time if the state's school construction program was fully funded. CUSD has been able to combine Mello-Roos funds and developer fees for its 50 percent share of our ten approved current projects. Without Mello-Roos bonds proceeds of approximately $93 million we would not be in that position.

3. What are other viable options that exist in addition to Mello-Roos financing for addressing school capacity issues?

   This is an interesting question in that I think we need to look at it from a financial concern of other financial mechanisms available to districts, as well as maybe other non-financial or potentially perceived non-financial mechanisms. Other financial options might include the use of general obligation bonds which has been mentioned.

Brown: Local or state?

Doomey: Local. We would certainly love to see a majority vote for local bond passage for the approval of school facilities in California. Hopefully, we are following ACA 6. We know that it is running into some difficulty, but we are actively following that, as well as some other potential legislative measures that have addressed simple majority vote issues in California such as Senator Greene's bill, SB 485, for simple majority vote for Mello-Roos school districts.

Developer fees are another area that provides a financial vehicle for addressing capacity issues in California and for school districts, but due to the economic conditions today the developer fee fund income has been drastically reduced. Redevelopment agencies provide a third mechanism for potential revenues. But again those funds usually come some time in the future and must be carefully evaluated when preparing a financial plan. Potentially, two other ways to evaluate school capacities would be the use of multi-track year-round education or possible double sessions.

Respectfully, I'd like to make the following recommendations concerning strengthening the Mello-Roos Act.

The first would be that the initial homebuyer in our districts receive a notice of a special tax lien which is signed and then submitted to the district as verification that they are aware of the special tax. However, subsequent homebuyers are only notified through the preliminary title reports that appear on the property. I think it would be helpful if secondary buyers also had some vehicle in which the special tax was specifically identified for them.

The other recommendation would hopefully be to reduce the vote requirement for the passage of Mello-Roos bonds to a simple majority vote, as has been addressed in some legislative pieces in Sacramento.

The Capistrano Unified School District currently has five Mello-Roos community facilities districts in which we have sold bonds in three of those districts. We have worked very cooperatively with whom we feel are very proactive developers and realize that there is a tremendous need for school facilities in California. The position has been established in the district, the Director of Facilities Funding Administration, who works as a direct liaison to members in the community, bond counsel, to evaluate all of the questions and concerns that may come up in our districts regarding our Mello-Roos financing programs. The team has been extremely beneficial and helpful.

We have reviewed the project evaluation guidelines as outlined in the September 1991 report by CDAC, and we have implemented all of those guidelines since our first district was formed in 1987.

And I'd be happy to answer any questions if you may... And I also have a copy of my presentation.

Brown: Great. Any questions?

Burton: Is your Mello-Roos district contiguous with your school district?

Doomey: No, it is not contiguous with the school district.

Burton: So you have overlapping Mello-Roos districts within the school district?

Doomey: We have districts that are set up in certain pockets of the district. We are a 200 square mile school district, and many areas of that school district are in the development stages at this point.

Burton: Okay...So the point that was raised earlier by one of the taxpayers who spoke was that (I think it was the man from Tracy) their Mello-Roos district has built the schools to which their children are not allowed to go. Does that happen in your district?

Doomey: That won't happen in our district. I might add personally, that I do pay a Mello-Roos tax myself in the City of Irvine and have for the last five to six years and feel very strongly in the support of that, not only as a taxpayer but as an administrator of CFD districts.

Burton: Do you know whether if you had a school district-wide vote if bonds would pass with the two-thirds vote?

Doomey: Interestingly enough our district did have a district wide vote. We received 52 percent of the vote. The simple majority issue is one that is a major concern for school districts because at two-thirds majority vote it is extremely difficult to get the voter approval, and majority would certainly make a major difference.

Burton: And districtwide, are you on year-round schools?

Doomey: We have two schools that are on year-round.

Burton: Okay.

Brown: Thank you very much for your testimony. Are there any other questions. Next speaker is Mike Vail, Coalition for Adequate School Housing, or CASH. Mr Vail.

Vail: Good morning. As you mentioned I'm the State Chair of the Coalition for Adequate School Housing and also the Senior Director of Facilities at Santa Ana Unified School District.

Just briefly, I wanted to start by describing CASH and what it's trying to do. It's a true statewide coalition of the fastest growing school districts in the state, plus others that are interested in financing for school construction. In the past, CASH has provided leadership for all the statewide school construction bond measures that have been before the voters of the state since 1980. As you know, all of those measures have been successful and have raised about $4 billion for school construction. CASH has also been involved in the formation of almost every piece of legislation that has been passed by the State Legislature since 1980 affecting school facilities. And CASH now has on the table during this current legislative session a major proposal for reforming the State School Building Lease-Purchase Program, which you've heard several times now is inadequate to meet the needs in California. And I'll talk about that a little bit more in a few minutes.

My purpose today is to review with you the challenge that's facing California school districts in the area of facilities. And in that regard I feel almost like I'm speaking to the choir with the parties that are here and the involvement that they have had in that issue, including the membership of Ms. Burton on the State Allocation Board. But to briefly review that, the State Department of Finance believes that K-12 enrollment in California is going to continue to grow at about 230,000 students a year during this present decade. At the same time, the State School Building Lease-Purchase Program has about a $6 billion plus backlog in applications waiting for funding. And the State Department of Finance estimates that that backlog will grow by the year 2000 to approximately $30 billion of need for new construction. So we truly are facing a school facilities crisis.

If we compare that current and projected need to the available sources that we're familiar with, we know that we're collecting between $350 million and $500 million annually in developer fees. In the past, statewide general obligation bonds, those bonds that I spoke of that CASH has been in a leadership role in obtaining passage from the voters of the state for, are garnishing about $600 million annually for new construction on average. So we're looking at developer fees and state general obligation bonds generating less than $10 billion over the next nine years to meet what we think is going to be almost a $30 billion need. This projection assumes that voters are going to continue to support statewide school construction bond measures. I think we all know that the last proposition that was presented to the voters in November 1990 got a less than 52 percent "yes" vote, and that was before we truly entered the recession that we're all experiencing now.

Additionally, the State Department of Finance has issued a report which suggests that 1992 state school construction bond measures would be the last statewide bond measures for school construction purposes. So there is even uncertainty as far as Sacramento support for continuing to have statewide bond measures for school construction purposes.

Districts are able to present local bond measures to the voters within their district. But as you've heard and as we're all familiar with, that requires a two-thirds vote. Every "no" vote counts twice, in other words. It's not democracy. It's not vote of the majority. And because of that law and because of the rules that we have to comply with, on the ballot in November, only eight of 35 local bond measures put before the voters of various districts by local school districts passed. Eight of 35 only were successful.

Brown: It's astonishing that eight passed the two-thirds vote in the face of the other problems.

Vail: ACA6 we've heard about today, and that's part of CASH's comprehensive platform. We believe that it's fair to ask for a majority vote on bond measures that would build schools for an entire community. We feel that the community should be supporting school construction.

As you may know, comprehensive information in the use of Mello-Roos by school districts is not available. What is available is outstanding Mello-Roos debt by school districts for school construction. As of July 1991, that debt equaled about $565 million which will someday translate and is currently translating into literally thousands of new schools. As I mentioned, what we don't know is authorizations that have been gained by local school districts using the Mello-Roos. Clearly, Mello-Roos is a major school construction funding source at this time. We can only speculate what the authorizations might be, but I'm sure they're in the hundreds of millions of dollars.

In the Coalition for Adequate School Housing, we've heard of the criticism that's been levied against Mello-Roos. We would support any reforms that make sure that investments are made soundly with Mello-Roos funding, and that the money is utilized properly--and I think that the testimony from other public agency representatives today indicates that there is a great deal of discretion currently being used in the use of Mello-Roos. For instance, with the debt to lien ratios we've heard about and the limitations on total debt. We, within our coalition, are unaware of any widespread problems with school districts using Mello-Roos funds. We have not heard criticisms or complaints that would indicate to us that there is any widespread problem.

And to conclude my testimony I would simply emphasize the fact...

Brown: You're not familiar with the Tracy school district concerns?

Vail: We know of isolated incidents where there have been problems. But if you talk about widespread concern in the list of districts that are currently using Mello-Roos, both as far as bonds that have been issued and authorizations, the problems have definitely been in a minority of school districts.

I would conclude my testimony today by stating that it would be a tremendous tragedy as far as our coalition is concerned if the baby was thrown out with the bath water, and this very valuable tool was tampered with to an extent where it wasn't one of the menus of funding sources that was available in the future to meet this tremendous school facility crisis that we're currently dealing with.

Brown: Thank you very much. Questions? You've answered all the ones that I had. Thank you very much. Next, we turn to the developer perspective and first is Mr. David Booher, California Council for Environmental and Economic Balance.

Booher: Morning. Treasurer Brown, Senator Bergeson, members of the Commission. I have written comments for you if you would like to have them.

Brown: We'll get them, and we'll receive them and enter them into the record. Thank you.

Booher: My name is David Booher. I'm representing the California Council for Environmental and Economic Balance, which is a coalition of business and labor that's been active for several years in the areas related to California growth and infrastructure financing. I'd also like to tell you that I have Mr. John Murphy here from Stradling, Yocca, Carlson, & Rauth--if you throw me any technical questions I can't handle--to call up, but he doesn't necessarily endorse my comments.

We were one of the original sponsors of the legislation that ultimately led up to passage of Mello-Roos. And we were because we recognized the implications of Proposition 13, and we recognized the implications of the shutdown of federal financing of infrastructure when those events first happened. And we've been asked to present the developer perspective here. Now, given all the developer bashing and Mello-Roos bashing that's going on, I kind of feel like a flower at a skunk party.

But I want to make my comments brief--maybe I should have made them even briefer!

Brown: Please do try and keep them to the five minutes. All flowers at skunk parties are limited to five minutes.

Booher: So I'm going to focus on the questions that the Commission posed. They're divided into two categories: (1) What do we perceive about the existing situation and (2) what do we think needs to be done?

First, the existing situation. The major advantage of Mello-Roos financing is what it was when it was passed. It provides a means of providing the capital up front to finance infrastructure to accommodate new growth and development. You can't provide it all with developer fees; you can't provide it all with assessment district financing because we're talking about infrastructure that doesn't just serve specific homeowners. Mello-Roos tax is a *tax*--it can benefit the general public. Some of the infrastructure that has to be provided, because we can't provide it since Proposition 13, is general-based infrastructure like the schools and so on. That's also the major disadvantage. One of the questions was "what's a major disadvantage?" Well, because it can provide that flexibility, and because it can finance infrastructure for the broad-based benefit of the community, that's a disadvantage because we, as developers, are having to load the price of that enhanced infrastructure for the broad-based community on the potential customers to buy those houses. And so it's a balancing act. It's a balancing act for the developer; it's a balancing act for the local government. That's the advantage and disadvantage.

On the housing cost--what's the effect of Mello-Roos on housing costs? We pretty much agree with the assessment of the Commission's report on that topic. In some cases Mello-Roos does result, to individual homeowners, in a reduced cost. In some cases it doesn't. And it just depends how it is done in that community. But the major thing here is not the cost of financing. The major issue here is to the extent the local government requires the proponents of a development to finance broader-based community facilities for the entire community. Obviously, that's going to result in a higher cost to those homebuyers than if it was financed with development fees because under existing laws, development fees can't be higher than what each individual property owner is going to benefit from those fees. So the analysis in your Commission report is pretty accurate in terms of the basic issues here.

Now you ask the second of two questions, which relates to what do we think needs to be done. And we have some suggestions on that and have had some suggestions. I'm going to divide it up into two categories which the Commission report dealt with: what I call project evaluation and disclosure and then the planning issues in the Commission report.

First, on project evaluation and disclosure we agree basically with the guidelines that the Commission came up with in terms of project evaluation. We wouldn't necessarily support enacting that into legislation. But we would support legislation requiring local governments or CFD district governing boards to review these guidelines each time they act in this area, and even certify to the Commission, or some other appropriate state body, that review of the guidelines in the context of this particular CFD had been done. And we would support the Commission on a periodic basis looking at this issue and updating and revising those guidelines to recognize what's been going on.

Secondly, on the disclosure we also would support earlier disclosure to the homebuyers of the Mello-Roos implications. I think there is some, having closed on a couple of loans myself as a homebuyer, there is some amount of stress when you go into an escrow office and are presented with this stack of papers. And we can understand that. I think what needs to happen here is at the time the purchasing document is signed, that's when the disclosure should take place--not only the level of taxation, but some of the issues that people are concerned about that have been raised here today; so, up front, the homeowner knows. And we would support legislation requiring that.

Now on to the planning issues, which is really what this is all about. What it comes down to is people want to have the infrastructure, to have high quality communities, but nobody wants to pay for it. You know, the new homebuyer whose coming in now and paying these Mello-Roos taxes, they don't want to have to be paying when the people are already there. And this is intrinsic to Proposition 13 because Proposition 13 basically creates a situation where you have a disparity between new homebuyers and people who have been there for a long time. And that's a fundamental issue, and Mello-Roos works around that and can't solve that. But we believe that two things have to happen here first. And I'd like to incorporate the Treasurer's comments at the beginning into our comments by reference because we've got to have broader-based financing for infrastructure, and we've been pressing that for several years. Secondly, we've got to integrate infrastructure financing into the planning process. Specific recommendations that you'll see are: we support legislation and a constitutional amendment providing for a majority vote for local bonds for infrastructure. There's nobody who is better aware of the problems we're having with ACA 6 in the Assembly than I am, and I don't know what's going to happen.

Brown: You are supportive of that in your organization? And who you represent would be supportive of that?

Booher: Yes we are. That is correct, and the constituents in that organization. Now ACA 6 though, I caution you, only deals with schools and jails, and there's a lot more infrastructure at issue here. But that's a good first step. And we strongly support that. We also support requiring local governments, as part of their general plan process to include a capital improvement program. And we supported that for a number of years, and have had resistance.

Brown: Very good. If I could just ask you to sum up. We're running over our time. I've been handed a note that I have to "pick up the pace." So talk fast...

Booher: Okay. Well, that was the last, actually that the last... Oh, the last recommendation is the Commission report called for integrating school facilities into the general plan. We have supported that in the past and continue to support it along with requiring it to be consistent with the general plan and requiring schools to improve efficiency like year-round schools and those kinds of things. Thank you very much.

Brown. Very good. Thank you very much. Any questions from the Commission. Thank you. You answered questions that I had. Next speaker is David Celestin, and he is from Orange County.

Celestin: Thank you and good morning. In respect to your last comment, my comments are less than five minutes. We do have a handout which is a position paper by the Building Industry Association of Orange County. My name is David Celestin. I am President of the Building Industry Association, Orange County Region. I am also representing the Building Industry Association of Southern California. BIASC represents over 2500 member companies, or approximately 25,000 people from the counties of Ventura, Los Angeles, Orange, Riverside and San Bernardino.

The passage of Proposition 13 and the resulting ebb in the flow of revenue to state and local government changed dramatically the way that infrastructure and capital improvements necessary to accommodate growth was funded and provided. Since 1980, emerging new communities and growth areas have been required to fund the infrastructure and capital improvements needed. These improvements go beyond typical subdivision exactions to include regional transportation systems, schools, fire stations, libraries, public safety facilities and other capital facilities. These improvements were traditionally provided by government.

The end result in the shift in responsibility is higher home construction costs, higher home down payments, and higher mortgage payments. As traditional financing became less available, developers turned to alternative sources. Legislation drafted by Henry Mello and Mike Roos and enacted by the state provided that needed source. Because public infrastructure and capital facilities improvements can now be funded through Mello-Roos capital facility and district bond proceeds, construction of roads, sewers, storm drains and other public works projects can be accelerated. Schools, libraries, fire stations, police facilities, court and civic center facilities can be in place when needed. Housing becomes more affordable with lower down payments, lower mortgage payments and lower tax exempt interest rates on the Mello-Roos special tax, as opposed to paying a higher interest rate on home mortgage to pay for community infrastructure.

Taxpayers are clearly told that they are in a Mello-Roos district and that their tax rate will be approximately 2 percent. The buyers are signing separate disclosure documents to that effect. In general, the disclosure has been greater than that provided any other taxes that will appear on their tax bill. However, due to the sudden interest of many, it may be appropriate to provide the homeowner with even greater detail, and the BIA is working on an expanded format that all builders can use. To assure a better understanding of the benefits of Mello-Roos programs by homeowners and buyers and others, BIA is working with real estate groups to develop a more informative disclosure program. The program will utilize a separate and distinct form that will be simple and understandable and that will explain what public infrastructure and public facility projects are being financed through the Mello-Roos special tax.

In closing, let me offer the following comments. Until government can reassume its prior role of financing public infrastructure and capital facilities, Mello-Roos is the best and only source of funding available to us. Mello-Roos helps to keep housing affordable to more people. Mello-Roos assures that infrastructure and capital facility needs to accommodate growth are in place when needed. There's an old saying: "if it ain't broke, don't fix it." We don't believe the Mello-Roos is broke. There are some problems. Problems related to public misinformation, misinformation fostered by inaccurate and distorted newspaper articles, and also disclosure. BIA, as I stated, will cause a better understanding by the public and will develop a simple and understandable standard form on disclosure for not only the first-time buyer but subsequent buyers as well.

There was an early question asked relative to support of a constitutional amendment. All the BIAs throughout this state, and I know for sure this region down here, have directed the California Building Industry Association to become very active in support of the simple majority vote for capital improvement facilities and infrastructure needs. At the end of this month, the chair of our legal committee for BIAOCR has convened a meeting with the real estate people, with the builders, and with developers to begin development of a standardized form of disclosure that will make it clear to our buyers, and so to ensure that our sales people in our model home complexes have a better understanding and are more capable of disclosing what Mello-Roos is all about and what is happening. And finally, we are having a workshop on Mello-Roos on the fifth of February. The Building Industry Association urges this Commission to resist the urge to tinker with a program that is working well, providing needed infrastructure and capital facilities in a timely manner and helping to keep housing affordable. Thank you.

Brown: Thank you very much. Are there questions. Our next speaker is Ursula Hyman from Latham & Watkins.

Hyman: Treasurer Brown, members of CDAC. My name is Ursula Hyman, and I'm a partner at the law firm of Latham & Watkins. But I'm not here speaking from the legal perspective but rather because I represent a wide range of developers, both in the urban context as well as the raw or undeveloped land context which have used Mello-Roos. And since we've responded to the questions in writing, what I wanted to use our time for instead was to respond to some of the comments made earlier.

First of all, we support, and I think everybody accepts, that well-planned growth is in fact necessary in California, but it's also desirable. It provides jobs; it provides homes; it provides opportunities for people entering the state. We support ACA 6 but quite frankly we're not as optimistic as others might be about whether or not this will be a panacea at all for curing the problems we have with financing infrastructure. We're very concerned that the same kind of movement we see in no growth areas will apply when ACA 6 types of bonds or measures are put before the people because there is always that tendency: "I don't want to pay for it in the future."

There was a suggestion made that a state clearinghouse be formed or some kind of state oversight group. We, in fact, would oppose that. Right now one of the biggest problems we have in the State of California is time delay. Land use entitlements can take in some areas years. And if we add one more step, one more mechanism, one more bureaucratic level that has to be gone through, we see both additional time and additional money being spent. And quite frankly, additional money being spent, in whatever form, gets passed through to the homeowners in some sense of the word.

Ms. Walsh mentioned, and I think she's the only person who used this phrase, "partnership." And that in fact is what Mello-Roos should be and what we urge jurisdictions to do. Use Mello-Roos in partnership with the developer community, and in fact sometimes that developer's lending community, to plan an integrated financing plan moving forward in the community. That's why one of the suggestions that we should allow a vote partway through, once some residents have moved in, to adjust the financing scheme is so very potentially dangerous and why the act is written as it is now so that while the developer holds 51 percent of the land, that plan can't be changed. If you have started with a master plan with respect to your financing and have it changed midway through, your lender will have a problem and the future homeowners will probably bear an even greater disproportionate cost. In addition, as you started to front end infrastructure you're now going to be in the situation where you back end it.

Just a few comments on the concept of benefit because that's a very difficult concept, and we've grappled with that issue with some of the earlier speakers. First of all, part of the problem is you want that infrastructure to outpace the growth so that things such as sewage treatment plants have to be built as a whole--you don't do it sort of in little parts--and yet it has a capacity that exceeds that which is needed for that new local community.

The ideas that are implemented in the County of Riverside and other jurisdictions, such as the County of Los Angeles, are very helpful where fees are collected later from subsequent developers and then used to reduce debt service. But that's not always going to happen because costs grow and other needs happen. And when new developments occur in the future, there sometimes is just not available money there for that type of infrastructure. So new communities are paying for the right to develop in certain areas.

The other concept is how do you measure benefit? And I understand the concerns of the person who testified from the City of Tracy. But you have to take a look at a broader concept, I think, when you think about benefitting a school district. Hopefully, in our school district you have a wide range of schools. Some are older, some are brand new--but the level and the quality of the education should be the same, whether or not that's the brand new building down the street or one a little bit farther away in the district. And hopefully, if they've got problems with their district there, they should be fighting that; but we certainly should not move to the idea that the school that is built, the absolute school down the street or down at the corner, must be the one that the taxpayer attends. There are other benefits received. A community that has a good school district has a higher value in its homes. We all know that. They're perceived as a better place to live.

Brown: Not if you can't go to that school.

Hyman: In that school district... However, I think that should be the central issue--is the school district and the quality of the education throughout the school district as the school district in Los Angeles is facing?

The question of disclosure: we've made some recommendations as well. We support the concept of subsequent purchaser disclosure. The current real estate transfer disclosure statement that's required under law for subsequent purchasers could easily be amended to include information on a Mello-Roos tax. We agree that the preliminary title report is sometimes a document that just terrifies people and they don't read when they're a subsequent purchaser. In addition, we recommend that the current exclusion in the Mello-Roos Act to allow you to use the Department of Real Estate guidelines and include your disclosure in the DRE report not be allowed. That, in fact, either that act should conform to the Mello-Roos Act, or we should have stand-alone Mello-Roos disclosure that is given earlier.

And finally on the letter of credit concept: we support the approach taken by the County of Orange which is a much more individualized concept. To uniformly require a letter of credit is probably again going to cost, in the long run, the homeowners. The individual background on quality of the developer in question should be considered. And in addition more creative alternatives should be considered. For example, if you think of this as a partnership and you work with the developer and the developer's construction lender, you can arrange for the construction lender to hold back a certain amount, equal to one-year Mello-Roos taxes for example, to be assured, or under the credit agreement that that be a requirement--that there always be held back in the loan amount available an amount to pay special taxes. That gives the lender an early warning signal and they can move in before there's any nonpayment of taxes.

We have also made a number of technical suggestions to the act which we found that the use of Mello-Roos in the urban context, and recently you've probably read that the City of Los Angeles just formed what I believe to be a landmark, public-private partnership CFD district, where the community redevelopment agency joined with 18 property owners in the middle of Los Angeles to refurbish Pershing Square. But in that process we have found items in the Act that need technical correction and we've made suggestions.

Brown: Very good. Thank you very much. I do appreciate your responding to the comments as they've been made. Senator Bergeson.

Bergeson: Ms. Hyman, considering concerns over devalued property at the present time and perhaps the comfort level of those that would be investing in the Mello-Roos bonds, what would your response be to a mandatory bond insurance for developers so that in the event of default it would fall with them, as opposed to on local government?

Hyman: I don't believe at this point that such a program would be acceptable to the insurance community. If we could find such a program I think our response to it would depend on what the terms would be, and what the additional cost that would ultimately be passed either to our commercial tenants or the homeowners would be.

Bergeson: But would you feel that this might perhaps give a greater level of comfort to the investors who are a great concern right now?

Hyman: We would not be adverse, for example, to the state considering a reinsurance program of some sort, similar to what's used in the health care industry and some kind of alternative along those lines. But we're just not optimistic about any opportunities in the commercial insurance market, but we could support them depending on their terms.

Brown: It's analogous to the letter of credit. It's the security for the bond holder, and if I heard Ms. Hyman's comments correctly, she was less inclined to be supportive of a blanket letter of credit which is analogous to bond insurance, but to take it on a case-by-case basis along the lines that Orange County does, where you have a developer or you have circumstances that might make it more risky than to interject...

Hyman: I think you have to look at the package as a whole, and what the elements are: Who the developer is? Where is the real estate located? What's the history of the value? And so on. And make those individual decisions as you move together in the partnership mode.

Brown: Very good. Thank you. Let me just ask one last question. Would the clients that you represent be supportive of ACA 6?

Hyman: Yes, we support it.

Brown: Thank you. Next, from a finance perspective, John Gibson and Scott Sollers of Stone & Youngberg--this is the dynamic duo that has just exactly five minutes between the two of you.

Gibson: A little visual distraction. Madam Treasurer, Senator Bergeson, committee members. We appreciate the opportunity to be here today, and we look forward to continuing to work to improve Mello-Roos as a financing tool.

The recent downturn in the economy has emphasized certain aspects of planned secured financings that deserve this scrutiny that we're giving them today. But overall we feel that the Mello-Roos financing is an extremely valuable tool that should be sustained. But we know it can be improved, and we're willing to work to help do that.

And we thank CDAC for your efforts to date. And the CDAC report is part of an education process that we think is important in the viability of this financing tool. And a point that we want to make strongly is that as the Mello-Roos financing tool has evolved and become more intricate, the market has responded with higher buyer awareness and sophistication. In fact, investor discrimination is helping to promote tighter underwriter criteria, issuer involvement and ultimately better security.

Now you asked us four questions. And I'm going to address three, and Scott's going to address the fourth one and make some general remarks. And we will keep it short.

What is your firm's objectives when structuring a Mello-Roos financing?

(Due to recording problems, the remainder of Mr. Gibson's and Mr. Sollers' testimony was lost. Accordingly, their written comments have been included in Section 2 of this report.)

Brown: Okay. Very good. The next speaker is Anthony Wetherbee from Chilton & O'Connor.

Wetherbee: Good morning. I am pleased to be able to speak to your committee regarding Mello-Roos. I am Anthony Wetherbee, and I'm with Chilton & O'Connor. My experience with Mello-Roos is both as Deputy County Counsel for the County of Riverside prior to mid-1986, and since then as an investment banker with Chilton & O'Connor. During that time, I participated in some 30 Mello-Roos issues totaling nearly $300 million. I've also participated in another 20 or so assessment districts totalling another $100 million. I mention assessment districts because while they're not quite as well suited to a new development situation as Mello-Roos, the credit analysis has evolved to be practically the same.

In my view, these financings have been extremely important for at least three reasons. First, they've been invaluable to the development community in providing low cost and available funds for construction of required public improvements. This source of funds has never been more important to developers than today when conventional funds for these improvements are essentially not available. It's a shame that so many erroneous articles concerning Mello-Roos have been circulated. The result is to make even this last vestige of funds more expensive by as much as a percent and less available. Secondly, Mello-Roos properly conceived, structured, and disclosed has been a benefit to homeowners. Mello-Roos tends to keep prices more affordable, qualifying somewhat easier, and total all-end monthly payments somewhat lower. But most importantly, Mello-Roos has made thousands of attractive homes available for purchase, that may have never been constructed without this financing technique. And third, Mello-Roos has been important to many governmental entities, especially in rapidly developing cities and counties where more public facilities have been made available sooner due to the reduced cost associated with Mello-Roos.

You've asked that I address a few specific questions, and the first of which is Chilton & O'Connor's objective when structuring a Mello-Roos issue. We truly believe for a Mello-Roos issue to work at all, it must work for everyone: the developer, the issuer, and the homeowner. If the developer wants too much, the issuer will generally not approve the financing. If the issuer wants too much in terms of additional improvements or unusual enhancement, the financing is no longer attractive to the developer who is motivated at least in part by margin concerns. And finally, assuming proper disclosure, the ultimate homeowner should reject a home with a special tax that's out of line. At the same time, we recognize that each bond issue must be fiscally secure in order to protect both bond holders and issuers. So what are our objectives? I say, initially, to facilitate productive communication between issuers and developers, making sure that they're each aware of essential concerns such as credit criteria and homeowner disclosure. Next, we must make sure that the credit works for both bondholders and developers. Besides just a sound financing plan, this security element involves working with essential consultants, such as lawyers and the appraiser, to make sure that they understand the plan and that they're aware of criteria proposed by the issuer and ourselves.

You've also asked if in this process we believe the interest of the ultimate taxpayer is protected. I do believe that that interest is protected. A well-informed developer is sensitive to market resistance, and a well-informed issuer is sensitive to taxpayer resistance. As the underwriter, we are sensitive to the fact that taxpayer displeasures are likely to raise tax delinquency rates and increase the likelihood of default.

Your third question was how vital Mello-Roos is in ensuring public service levels in developing areas, and what would result if it were easier for taxpayers to prevent the issuance of authorized but unissued Mello-Roos debt. Mello-Roos is essential in developing areas. We have been involved in cities where the population has quadrupled in a four- or five-year period of time. In such a situation citywide facilities have tripled under the pressure of development. Recreation facilities, parks, major roads, police facilities and general governmental facilities, such as small council chambers and outmoded office equipment, are all severely impacted. And Mello-Roos has significantly helped such situations. As to the easing of the taxpayer's ability to prevent the issuance of unissued bonds--well, that would not be positive. The issuer and the developer undertook the development pursuant to a plan. If that plan is subsequently thwarted someone will lose, and it's probably going to be the governmental entity that's been involved in that financing. On the other hand, we try to structure issues is such a way as to cause little reason or incentive for taxpayers to resist the future issuance of the bonds.

Your next question was if we foresaw any default of any Mello-Roos bonds that we have underwritten. The answer is "no". While declining property values and slow development is never good news, we believe that the California Mello-Roos law, combined with conscientious underwriting, has left these issues in a much different state, so to speak, than the often alluded defaults in Colorado. In fact, over 25 percent of our issues have been rated, and we plan to apply for ratings on at least another 25 percent shortly.

The last area you asked for comment was on the need or desire for additional legislation. There are some areas that could be strengthened. First, one consistent concern is disclosure in the secondary home sale market. While the law has been continually fine-tuned in this area, and while it seems to work as is, it could be better. One suggestion would be to require sellers to provide essential Mello-Roos disclosure, as sellers are now required to provide about such things as homeowners fees in condominium projects and construction defects. Another would be for this committee to expand on the appraisal guidelines that are alluded to in your report. It is my understanding that somewhat of a disparity has developed in appraisal criteria so the two issues represented as 4:1 may, in fact, be quite different securities.

And lastly, a methodology for bondholders to easily obtain fundamental facts regarding Mello-Roos issues on a current basis would greatly protect the secondary market in these bonds. This is because the security for Mello-Roos bonds by their very nature changes quickly and dramatically. We've attempted to ease that problem by applying for ratings once meaningful development has occurred. But this is not enough, since it can take too long for new issue to become rateable.

In summary, I believe that Mello-Roos works. Significant new restrictions would adversely impact an economy already in distress and governments already under great fiscal pressure. The emphasis is and should be on security disclosure providing necessary public facilities, the availability of affordable housing, and the economy. And in that respect I believe that the State of California has done well. Thank you.

Brown: Thank you very much. Are there questions from the Commission members? I don't have any questions; you covered it well. Do you have a copy of your statement? Mr. Harry Clark is next. Has he arrived yet? Fine. We'll be here--I will be here. David Taussig, Taussig & Associates. Actually, we're doing quite well. We assumed this hearing would go to 1:30 p.m., and if everyone continues to be succinct, we should... Oh, I hope they're quick overheads...

Taussig: They're very quick overheads. I'll be as succinct as I can. You did ask three fairly complicated questions. My name is David Taussig. I'm with David Taussig & Associates. Those are unreadable from back here...but I guess it will have to do...I've got copies of my remarks here which you can give out to the board members. Actually, I have much more detail in there than I'll be able to give in five minutes. I have a financial consulting firm. We do a lot of special tax consulting in Mello-Roos districts.

I was asked to talk today in my letter about some of the objectives we have in setting up these Mello-Roos special tax formulas and also talk a little bit about the developed property tax versus the undeveloped property tax and whether homeowners are somehow subsidizing developers. I know that's a key issue that's been mentioned several times in some of the newspaper articles that I've read.

Very quickly, the primary objectives in designing a special tax formula: you've got a developed property tax and undeveloped property tax. Developed property tax applies to properties after some point of entitlement, usually we use building permit issuance; sometimes we use re-accreditation of a final map, but building permit issuance is fairly common. So before a building permit is issued the property is considered undeveloped. Once a building permit is issued it's considered developed property. You understand that sometimes the developer owns the property and is paying a developed property tax because he hasn't sold the home yet. Once he sells the home then the homeowner pays that tax.

The four major criteria we use: (1) We always want to make sure that the highest special tax does not exceed some kind of community marketing political standard. That varies by community. Tim Davis talked before about Riverside County. They have a two percent maximum tax rate, two percent of the sales price, usually starting out with a tax rate around 1.1 percent under Prop. 13, so you've got an additional .9 percent or 90 basis points to work with. And that would be the worst case. The highest tax somebody could pay would be a two percent tax.

I work with Mary Turner, of the City of Anaheim. They're a little bit more conservative; they had a 1.7 percent maximum tax rate; so we're starting out with about a 1.1 percent tax; we're adding 60 basis points to that. So it varies by community. And developers are also very concerned because they have had a lot of trouble selling homes with Mello-Roos taxes. The higher the taxes the more disadvantaged you are in competing with other developers who don't have Mello-Roos taxes. So now we find many developers saying we don't want our taxes to exceed 1.5, 1.6 percent of sales prices. So that's one major criteria.

A second, which is very important, is that we have a very stable tax that's unaffected by any kind of development risk. Normally, we either have a level tax where a homebuyer buys a home. Year one, the tax is $800. It goes on $800 every year for the next 25 years. Or we have a two percent escalator. The tax starts at $800 year one; it's disclosed; there's a two percent escalator--just like Prop. 13, just like the regular taxes--tax goes up by two percent per year. That's $800 year one, $816 year two, $832 year three. We found over time, especially when prices were rising, that what we started out with as a 1.9 or 1.95 percent tax rate winds up being 1.6 or 1.65 percent tax rate, once the sale price increases have occurred. Remember that a normal property tax, when a homeowner sells his home, if the property value is higher on the sale, you've got that jump in taxes. With Mello-Roos, at least the programs that we work on, don't work that way. You continue muddling along at a set level tax every year or tax escalator by two percent per year unaffected by any kind of transfer of property.

Third, a major requirement: a 110 percent gross debt service coverage. Underwriters, investment bankers, and the investment community in general require that when Mello-Roos bonds are sold, that the maximum taxes that can be collected are not just enough to pay the debt service on the bonds but also an additional 10 percent to cover problems that might occur. So that you'll have developed property taxes at a certain level that's disclosed. The actual tax we'll collect will usually be about 90 percent of what we disclose. If worse comes to worse, there's millions of delinquencies; the reserve fund gets depleted and we have to replenish the reserve fund; the increased tax on developed property is a maximum of 10 percent. It goes right back to the level that was disclosed. We charge less than what was disclosed but if the defaults and delinquencies occur you go right back up to the level that was disclosed. And I'll show you a graph in a minute that shows that a little more graphically.

Last thing is that we always try to get our tax to reflect a level of general benefit that varies totally upon the particular type of program, the community, what types of facilities are being built. But generally what we do is use the size of the home as the line of demarcation. A larger home with more square feet will pay a higher tax; a smaller home with fewer square feet will pay a lower tax. Sometimes we do it on lot sizes. It depends a lot on the particular project and the types of improvements that are being built.

If you turn to the next slide, I'm going to show an example of a Mello-Roos tax--and this is very typical of the programs that we do. This shows what's happened in this real estate recession, or depression, or whatever you want to call it. We've got taxes on the board there. The blue lines are the lines for developed property. We have four categories of developed property. The largest homes are in the top category, and you can see the four other lines below that. You notice the taxes increased every year by two percent, and it looks almost like a level tax. But you've got a two percent escalator there. How about undeveloped property? Well, what's happened is the developer did not build nearly as quickly as he thought he would. So we've got taxes in the initial year that are $1,174 per acre. Those jumped up by 19.3 percent, not two percent, but 19.3 percent in '90-'91 to go to $1401. Then again there was no development occurring. The undeveloped property tax went up by 43.7 percent to $2,013. And finally, our projection for this upcoming year (I called the developer to find out how he's doing--this year he's not going so well again) we project a 41.8 percent increase, ending up at $2,854 per undeveloped acre.

All of the risk connected with development has been placed on that undeveloped property. It is what we call our shock absorber. It absorbs any problems that occur. The developed property, if you buy that home, you're locked into that two percent escalator per year from now until whenever the bonds are paid off. Undeveloped property, you've got a maximum tax which is significantly higher than what we project you have to pay. That maximum tax covers our worst case, our worst case scenario. And we got some brilliant people in my office who figure out some incredibly bad situations. What we've got now is not nearly as bad as what we felt was the worst case. And on this particular Mello-Roos project, which was a Lake Elsinore Unified School District project, the maximum tax on undeveloped property is $6,000 per acre.

Next slide. This shows the developed property tax. Again, the blue tax is what has actually been paid in 1991-92, or is being paid, by developed units. These are three-dimensional so it's hard to see from out here. On top of that is a very slim yellow layer. That's the 10 percent coverage I talked about before. That's as high as a developed property tax can go. Undeveloped property, on the other hand--the tax last year as a percentage of the value of the property was 2.01 percent of the value of the property. You can see that the maximum taxes on the other properties, the developed properties, start out at .91 percent on the largest homes, .95 percent on the second largest, .88 percent on the third, .77 percent on the fourth. So the maximum tax on developed property as a percentage of value of the property is less than half of what was actually charged on undeveloped property this year which is 2.01 percent.

The maximum tax, which is that $6,000 I talked about, based upon the latest sales prices of undeveloped property is 6.2 percent of the sales price of undeveloped property. So we've got, as an ad valorem tax, this Mello-Roos tax, is highly punitive towards the developer. The developer is basically paying six times the tax as percentage of value as developed property. Remember ad valorem taxes, that's in Prop. 13, that one percent tax is totally ad valorem, general obligation bonds, all the debt prior to 1978, not all but quite a bit of it, all based on a general ad valorem-type tax which is based on value. And Mello-Roos really is very negative. And a number of developers--and having worked with public agencies and developers in the past--have mentioned to me how much better off they'd be with an ad valorem-type tax. So when you're thinking about this being anti-homeowner/pro-developer compared to ad valorem, there's no question about it. This is much, much more heavy on the developer.

Next slide. Very quickly. This shows what happens. We've got that developed property in that lower area on the right hand side that is supposed to be blue but doesn't look very blue here, blue hatching marks. The yellow is the undeveloped property. They pay the difference until buildout. This is what the developer projected: six-year buildout. His latest projection is 10-year buildout. (If you can switch it to that.) You can see how much tax the undeveloped property pays. All that risk--the developed property doesn't come on line until later. We can only count tax a certain amount per unit. All we can do is wait and wait and wait until enough developed units come on line so that developed property carries the entire debt service. You can see the difference between six years which is what was projected in 1988, and ten years which is what is projected now, and in terms of how much more tax the undeveloped property pays.

The last question you asked was what I would think if legislation was adopted that limited undeveloped and developed property taxes to or required undeveloped and developed property taxes be identical. There'd be no difference. There are situations where we do have the same taxes on developed and undeveloped property under Mello-Roos, but there are also many situations where it would be totally inappropriate. For example, and this is so common, particularly in Orange County and also Riverside County, any time you have a planned community where you plan on having more than one bond issue--let's say it's year one--we go out and sell $10 million worth of Mello-Roos bonds. That's a million dollars of debt service a year, all paid by undeveloped property. Two years go by. We now are half developed, just for example, so we've got $500,000 being paid by developed property, $500,000 being paid by undeveloped property. Now we go out and issue that second series of bonds. Let's say another $20 million in bonds. Now instead of having $10 million in outstanding bonded indebtedness, we have $30 million in outstanding bonded indebtedness. Our debt service is no longer a million dollars; it's now $3 million. So let's see, the developed property was paying half a million before; now they're paying a million and a half. That means that I've just tripled the taxes on every homeowner in the district. If you want to talk about political suicide, that's it. I mean you might as well either not run for election again, or you're the head of your own recall committee because that's exactly what's going to happen.

We strongly believe that two percent escalator is as far as you can go politically on developed property. I'm all for having a limitation that the escalator cannot be greater than two percent once an individual moves into the home. I think that's fair. Having that kind of situation would not work at all.

I've also worked in many communities where--this particular project here, Horse Thief Canyon--where they planned on certain densities existing. You're saying, let's see, undeveloped property looks to see what the zoning is. The zoning is 10 units per acre, so we're going to set a tax--a thousand bucks per unit is $10,000 on that acreage, and we're going to charge that land developer $10,000 per year. Four years later this recession has occurred. The developer comes back and as he's doing now completely reformats what his plan is. What was ten units per acre is now five units per acre. Can we change the tax? No, it's $10,000. All of a sudden we have five units paying $10,000, once development has occurred, instead of ten units. Is that below two percent of the sales price of the home? Maybe, maybe not. I run into assessment districts all the time where I'm brought in to do a Mello-Roos by school district. I'm told, "don't exceed two percent." I go out and look at the existing overlapping debt. The assessment district is already above two percent. I'd have to have a *negative* tax to get *back* to two percent. So, it just doesn't work in that situation.

And lastly, in rural areas in particular where we have a developer coming in. He needs to build an overpass. He doesn't have the value of the property to do that. We ask the surrounding landowners, many of whom are farmers who may be selling their property in the future for development, to help join into the program. Help give us enough value to go out and sell enough bonds to build the overcrossing. We go out there and we say, gee, the undeveloped property tax is going to be $10,000 an acre, and those guys--they make $10,000 a year, $20,000 a year--they couldn't possibly pay that per acre. So what they would do is refuse to participate in the program. We often have to entice landowners who are not going ahead and developing right now into participating in these programs by offering them a low tax rate until they get a tentative map approved, or a final map recorded. Then they're considered developers, and they go into another undeveloped property tax rate which is significantly higher. It's very important to have that kind of flexibility if you want them to participate in the program. And to be perfectly honest, if I was a newspaper reporter and I was looking to find something about landowner taxes being low and looking to change something in legislation--I'm all in favor of the Williamson Act--but that's the first place I'd look. Compared to Mello-Roos, the Williamson Act is really a break for landowners because agricultural land is taxed at such a low level. Now I understand there's a purpose to it; but compared to the Williamson Act, Mello-Roos is no abuse at all. It's totally different. Much, much more minimal in scope, I think. Anyway, that's it in 25 words or less.

Brown: Actually, 12 minutes or less. You did try, and I like fast talkers. You did really great, and I do like a lot of these folders. You did give us a very thorough and very helpful analysis and very much focused on some of the tough questions that we're looking at. One question that I would have: you do seem to argue, and with the documentation you presented, that there is not this inequity between the developed and the undeveloped land. We hear differently. Do you have any documentation for those other Mello-Roos districts that are out there? Can you quantify the number of districts that you represent, or you are familiar with, where this where this is not the case as opposed to those you might not be familiar with?

Taussig: We're administering about 35, and I know the maximum tax in every single one of them is significantly higher for undeveloped property than developed property. Now whether the actual rate charged is higher depends upon the level of development. So it does vary in each case. I guess I'm just saying you can set a floor on undeveloped property if you want to, where undeveloped property has to pay at least a certain level to make sure they're paying something. That might be one way to work it. I just think if you mandated something like that you'd be really hurting yourself. You would not be able to do a multi series Mello-Roos CFD. And Aliso Viejo, Mission Viejo, Santa Margarita, or any of the large planned communities out in Riverside County--they're all multi-issue districts. You've got to set this whole thing up year one. You have to set the taxes up year one. And to have equal tax on developed property and undeveloped property would mean you'd have giant leaps in taxes on developed property. Now, I suppose you could disclose that to the homebuyer and say, "your taxes could go up by 41 percent in 1993." It may make it tough to sell homes to do that. That would be one way you could work that. But I think a lot of people don't budget or are not prepared for that kind of increase, particularly elderly people on fixed income. And the fact that you have a stable tax, or two percent escalator, is so important on developed property that I really think that that's so important that you really shouldn't do any kind of legislation that has that effect. There's another question there...

Brown: Yes, Mr. Juarez has a question.

Juarez: What about if the floor--you brought up this point--were the developed property tax rate?

Taussig: Okay. You could work it that way. But, again, you'd have the same problem on multi-series districts. You'd have developed property carrying so much of the burden that if you suddenly had another sale of bonds, you'd have to have that increase in developed property tax. I think it would be very difficult to work it otherwise. I had not thought about it being that exact same level. Usually, it's below the level per acre that developed property is paying. It's something that might work. I have never tried it that way.

Juarez: I'm saying if the developed rate is the floor, then you still have the ability to put the risk on undeveloped property, as you indicate is done with Lake Elsinore. That approach is different from what we've been hearing about. That's why it's interesting.

Taussig: That is correct. All of ours work that way. So... And I would be glad to sit down with you--obviously, we don't have the forum here to do that--and go over all that in detail.

Brown: Great. We appreciate that. Other questions from the Commission members? Thank you very much. Next speaker is Joe Evans from Empire Economics.

Evans: Good morning. Joe Janczyk Evans with Empire Economics. In preparing my comments today, I gave serious consideration to taking some speech lessons from Dave Taussig. I thought it might have been expensive in terms of his fees, but in retrospect it would have been well worthwhile. I'll keep that in mind for next time. I'll try and keep to five minutes. I believe I can.

Briefly, my educational credentials are as a Ph.D. in economics. And previously, I was an economics professor at California State University.

During the past six years, we have conducted market absorption studies for over 80 Mello-Roos assessment districts, primarily in Southern California. Furthermore, we do not conduct market absorption studies for developers and builders, so that we do not have a potential conflict of interest in providing services to public entities. Before I get to the two points which will directly affect the opening comments by Chairperson Brown on the impacts of the recession and how much purchasers of homes pay, I'd like to first of all emphasize that the market absorption study provides the economic framework for the entire bond issue because it's used not only to inform prospective purchasers of the marketing prospects of the project and the potential risk factors, but additionally it goes into the appraisal to do a discounted cash flow analysis. And furthermore, it goes into the special tax analysis to evaluate how much the property owner will be liable to pay. Consequently, a conservative market absorption study, when used properly, results in the entire bond issue being approached from a reasonable perspective.

My first of two points is as follows: that the use of an independent market absorption study consultant who utilizes a conservative, economic framework for evaluating the absorption prospects of a project does, in fact, provide a reasonable level of security for the bond purchasers as well as for the issuer. As an example of this, we were retained by Orange County to conduct a market absorption study in March of 1990. Despite California's continued economic expansion over seven successful prior years, Orange County (based on discussions I had with Eileen Walsh) opted to use a recession scenario. Orange County took a recession scenario perspective in March of 1990 despite the fact that the recession did not even start until July of 1990. I have a copy of that study here which I'll submit to the committee.

As Orange County went through the year issuing additional Mello-Roos bonds, we constantly evaluated how the recession scenario looked relative to what was actually occurring. We did that in each bond issue that was offered, and we found that recession scenario in Orange County's framework was below what actually occurred for 1990. And I have for the committee a bond issue done in October of 1990 which specifically compared the recession scenario expectations with what actually transpired in the marketplace. So in conclusion, I recommend that the absorption schedule come from an independent market absorption study consultant rather than the builder/developer property owner. And furthermore, that that consultant use a conservative economic scenario. We've seen these scenarios utilized not only by Orange County but also Riverside County, Los Angeles County and San Bernardino County.

The second and final point I have is as follows--and this is extremely important, I believe. The marketplace is currently discounting prices of homes so that purchasers are effectively paying for the Mello-Roos improvements through the special taxes only, rather than also through the price of the homes. Thus, purchasers are not in fact paying twice. Since we have been doing market absorption studies for Mello-Roos districts over the past six years, we have conducted studies on a semi-annual basis which looked at over 1,000 active residential projects in Southern California. We then made adjustments based on the locations of those projects and other factors, the resulting final price differential reflecting the difference in the projects attributable to the Mello-Roos special tax. What we found is that the discount will vary by location, by product type and price range. But in general, for each dollar of special tax per year, the price of a home is lower by some $8 to $10 given adjustments for all other factors.

Brown: The total price or...?

Evans: The total price. So for instance, if we have two projects each selling $200,000 homes and one project has a special tax of $1,000 and the other one has no special tax, the project with a special tax will have a price of $190,000 and the buyer of the home assumes a special tax; and the other project that is otherwise comparable will have a price of $200,000. We've confirmed that through statistical studies (and we have gone to over 250 projects and interviewed sales representatives). What we have found is that during the past two years this price differential has become clearly identified. And we attribute it to two reasons, one of which you've heard a lot to date, the other one which will be a surprise. The first reason which you've heard is that there is disclosure. There is disclosure going. When we visit the sales offices we are informed of the project having a special tax. The surprising reason, which is fascinating, is that projects that do not have special taxes are aggressively using that as a marketing point to attract buyers to their projects. When I go to some projects that do not have special taxes they give me handouts which talk about the difference between the projected tax and the maximum tax. They talk about potential for a backup tax. Very, very sophisticated things that would certainly make a prospective purchaser aware of the special tax.

Brown: Very good.

Evans: So my conclusion here is that I recommend that disclosure be required as it is now, and that it be made as effective as possible based on a lot of comments we heard. And given that effective disclosure the marketplace will then result in the appropriate discounting.

Brown: Thank you very much, Mr. Evans. Are there questions from committee members? We appreciate your comments. And I think you did just fine. You don't need to take any speaking lessons from our previous speaker or anybody else. Next, we're going to turn to our legal perspective, George McFarlin from Orrick, Herrington, & Sutcliffe.

McFarlin: Thank you. Treasurer Brown, members of the Commission, and staff. My name is George McFarlin. I'm with the law firm of Orrick, Herrington, & Sutcliffe in the Los Angeles office, and in this type of financing we generally serve as bond counsel. Our responsibility with respect to that function is to identify all of the legal alternatives available to an issuer, to focus on the objectives of that issuer in performing this type of financing or offering it to the property owners, and to ensure there is compliance with the act and the tax law. The final step that we take procedurally is to issue an opinion which enable the bonds to be sold as tax-exempt bonds, and then we assist in the administrative process following the closing of the issue.

The legal issue which the Commission asked me to respond to was with respect to the landowner vote, and that is an uncertain legal issue that has not been fully resolved in the courts. The Mello-Roos Act has been around for ten years, and there still is no definitive case relating to the landowner vote. The issue really is that the constitution requires a one-person, one-vote scenario when the issue is of general interest to the public. In the case of a Mello-Roos, there is a relatively limited purpose for which the tax is being proposed, and that is the construction of facilities authorized by the act or provision of services, and in that instance, the landowner vote in some cases has been upheld.

One of the ways of getting around--not getting around--but getting comfortable with the landowner vote is through the validation process which many issuers and bond counsel require in putting together a Mello-Roos district. The two principal issues that are validated in that legal proceeding are the landowner vote, as I discussed, and also the fact that the tax is imposed on a reasonable basis in the CFD. Now you can tell from those two statements, there are words in each of those which require interpretation by the courts, and so far there has been no definitive interpretation with respect to Mello-Roos districts.

With respect to service levels without Mello-Roos--that's the third question that was posed to me in the letter from the Commission--that has been fairly well addressed by the other consultants. The limitations have been pretty thoroughly discussed in financing infrastructure and other community-based facilities due to Prop. 13. There are other land-backed financing alternatives, and specifically assessment districts, that have been around since before the turn of the century in 1900. Those, however, were rather limited to infrastructure type improvements; and, as someone mentioned, there is a requirement that there be a direct and special benefit from those improvements, and that varies from the reasonable basis that I talked about in the validation issue. And also Mello-Roos has the additional ability to finance more community-based facilities such as schools, parks, museums, libraries, justice facilities, things of that sort. The Mello-Roos has provided issuers with an additional incentive to provide homes, to provide commercial and industrial facilities, which in turn generate additional tax revenues for the community. So it is not without that benefit as well, as the projects are built out.

Finally with respect to recommendations for additional action, I perceive this (and I believe the Legislature did) as a local program. And as such to the extent that a local agency can adopt guidelines and impose policies with respect to financing this type of infrastructure and community facilities, I think it improves the program for that public agency. Obviously there is a need for a case by case review of each of the projects, each of the programs, as each of the facilities are being considered to ensure that they meet the objectives of the public agency with particular emphasis on the fairness issue so that one geographical area is not overburdened with the construction of these facilities. I also agree that additional disclosure to subsequent purchasers is needed. I must point out that when the act was originally enacted there was a gap there; and that in the years following, '84 or '85, the act was amended to require a notice of special tax lien to be recorded which does give constructive notice to the extent that's effective to purchasers and subsequent purchasers.

And finally, I believe that the State could do something in providing additional financing alternatives, particularly targeted at parks, schools, museums, justice centers, which would take some of the pressure off of Mello-Roos, which has kind of become a "catch all" for a lot of community facilities, as well as infrastructure. And possibly that's why the publicity has generated to the point that it has. Thank you very much.

Brown: Thank you very much, Mr. McFarlin. Are there any questions?

Burton: Just one. Could you be more specific about what the state could provide in terms of alternative financing?

McFarlin: What I had in mind was something similar to a Mello-Roos Act targeted more to, for instance, parks, recreation, which is a great use of Mello-Roos; or schools, which would be more facilitating to the approval, adoption, and financing of those particular improvements. Right now the Mello-Roos is being used for such a wide variety of improvements that it possibly could be split up with particular objectives being put in other acts.

Burton: Okay. If you have anything more specific than that I'd be interested in seeing it.

McFarlin: Okay. Thank you.

Brown: Very good. Thank you very much, Mr. McFarlin. Next, Marie Martineau from O'Melveny & Myers, who taught me everything I knew about Mello-Roos bonds at O'Melveny.

Martineau: Oh dear! With that kind of pressure...Thank you very much, Treasurer Brown and members of the Commission. I'm Marie Martineau with O'Melveny & Myers. And my firm and I have been doing Mello-Roos financing for some time.

My perspective is slightly different from George's, as I've been acting mostly as underwriter's counsel so I'm more on the disclosure end. And I'll try to answer the questions, although not necessarily in the order I was given. I was trying to keep it short, and George helped me quite a bit in that because I can echo a lot or agree with him in a lot of what he said.

My perception is that Mello-Roos financing has become necessary to local governments, especially in developing areas. We've heard a lot of discussion of other financing alternatives and they all have their limitations. I won't go into those. So I think Mello-Roos is becoming a tool. And, as George said, other mechanisms that could be used there would really need to be enacted. And I think the constitutional amendment allowing a majority vote would be very helpful. We all have stories of jurisdictions that have gotten 55 percent, even 60 percent, of the vote, but failed to get the two-thirds.

In terms of my firm's objectives and my objectives as legal counsel, in thinking about that question, they are really no different from any other type of bond deal. One of my underwriter clients says our job is to see that truth and light prevail, and I hope that's right. But to make sure the bonds are legal, the district was formed with all requirements of law, the bonds are tax-exempt if they're supposed to be, and that proper disclosure is made to the potential investors.

My job is made a great deal easier as counsel if long before the financing occurs the local entity has adopted guidelines that cover their policy decisions. The lawyer and the other experts are really supposed to implement the policy of the local jurisdiction, and I think they need to think that out well ahead of getting into the fray of a deal. On the other hand, I think that the lawyers and consultants have a real role to play in giving input on those policy guidelines. We've all been learning a lot as this process has gone along. And we've learned from each other's and our own mistakes, and learn from experience. So I think it needs to be a fluid process. And I think guidelines should be in place and should be periodically revisited in light of changing circumstances. I think the State has a real role to play there, and the Commission has already played that role and I hope will continue with their report setting out standards for guidelines. I think the State should be wary of actually trying to set guidelines for local issuers because a lot of the things that they have to respond to are dependent on local conditions. But I think that the encouragement of the need for guidelines is very helpful. And the education role is also helpful.

One area that I do think needs to be addressed more is disclosure. I don't really have anything to add to what George had described with our concerns with the landowner vote. We also require a validation suit when acting as bond counsel and like to see it when acting as underwriter's counsel. We have some concerns about the vulnerability of the landowner vote. And for that reason I'd like to see the notice to taxpayers strengthened. I think that a taxpayer who understands the process and knows what they're getting into is less likely to feel mistreated or that they don't have any method of voting, even if it is just with just their feet.

I remember my own experience buying a home, where you get a stack of paper like this, and my escrow officer was visibly annoyed with me because I insisted on knowing what each piece of paper was before I signed it. So I think that that notice process has to be earlier. The notice has to be given earlier in the process and not just at the closing. I also, having acted as underwriter's counsel, have a lot to say that I'll submit in the writing on disclosure to investors.

(Due to recording problems, the remainder of Ms. Martineau's testimony was lost. Accordingly, her written comments have been included in Section 2 of this report.)

Brown: Thank you, Ms. Martineau. Next, Greg Harrington from the Franklin Fund is with us today. Welcome, Mr. Harrington.

Harrington: Thank you. And I definitely do promise to make it as short as possible. I think your opening remarks, as well as all the remarks by many of the people that preceded me, I think covered the subject pretty well. So I will try definitely to make it brief.

I just want to say that I've been in this business 47 years--my gosh! And I come out after coming out of New York after spending 12 years in the business, and I come out here and I found there were some strange animals called the 1911 Act and the 1915 Act. Of course being a New Yorker--obviously a New Yorker knows everything about everything--so I couldn't imagine why I had never heard of this. But anyway, as I spent the next number of years living in California and watching it grow, certainly the 1911 Act and the 1915 Act played a tremendous part in development of the state. And of course Prop. 13 came along and certainly hindered the local issuers in taking care of whatever financing they needed, so Mello-Roos was born.

Now, I think I can probably best give you our feeling on Mello-Roos if I can give you a few numbers. As I recall there's about $350 million that's been issued, and we own $90 million of that $350 million. So obviously we like them. I think the last number I saw was something like 288 issues. We own 90. So obviously we think Mello-Roos is a good vehicle.

What about some improvements? What could be done? Well, we do have a few thoughts in mind there which I think would be helpful to those of us who are buyers. Probably if we could get a standardized appraisal format. I think that would be very helpful. Have an even playing field.

Brown: Standard what?

Harrington: Appraisal format. Then we do go over every issue we have. We have secondary issues, and we do review all the issues we own on an annual or semi-annual basis. And quite often we have difficulty getting the information from the local people. So we'd like to see something in an annual requirement such as current assessed values of the CFD, delinquency reporting, foreclosure actions, all fund balances, (We call and we can't even find out what the fund balances are in some cases. Now this is not true in all but in a number of issuances. In essence, we've got your money now, don't ask us any questions.) and all construction activity within the CFD as well as public improvements and project buildout. So I think if we could receive that information, certainly, we'd feel more comfortable. We can get some; some have been cooperative, but I'm sorry to say that we have met some resistance in certain areas.

Now we have a letter here where you did ask a few questions, here, where I'll try to answer, very briefly.

How has the investor's view of Mello-Roos bonds changed over the last six months?

Well, after you've seen those articles, obviously the public is concerned. And we at Franklin, because we are heavy holders of the securities, we've received numerous phone calls--we have over a million shareholders--and we've had a lot of calls from shareholders as well brokers and so forth who distribute our funds. The reporting, by the way, we found very unsatisfactory. When one reporter confessed that she'd just come off three years of bashing the junk bond business; well, she considered, frankly, that Mello-Roos was in the same category--that in her mind, Mello-Roos was junk bond. So we had difficulty in converting her to our thoughts that we did not consider them junk bonds. So...

Brown: They are unrated paper though, aren't they?

Harrington: Not all. We've had 10 percent of our bonds rated over recent months and we hope to have more. I believe somebody else made the statement just earlier that, what was it? Chilton, O'Connor mentioned it. That 25 percent of their issues have been rated.

Brown: How would you distinguish the Mello-Roos bond rated or unrated from junk bond?

Harrington: By the way, you said, which if I may take the liberty of correcting you... The very fact that a bond issue is not rated--I mean this bond is not rated--does not make it a junk bond. If you went to many states, you'll find a lot of issuance, even in the State of Connecticut, of course that might be a poor state to use at the moment... But I'm going to say they issue many

Brown: What other state can we use?

Harrington: But in a state such as that, but I could use Virginia. Many of their bond issues are small--small school districts, water districts, so forth. They're too small to rate. Fine credits. So for one reason or another, there's a lot of issuance of municipal credits that are not rated and should not be classified as junk bonds. And I think that's a perception that seems to be in the minds of the people.

Brown: And I just want to draw you out a little. What are the distinguishing characteristics between junk and the Mello-Roos bonds, which obviously have enjoyed wide support in the investor marketplace.

Harrington: Well, the number one perception out there, on the part of some of the reporters, and I think on the part of even some people in the fraternity--in the investing fraternity--is that they do compare it to the junk bond where if a bond did get in trouble, you go through a bankruptcy proceeding and you're lucky to get 10, 20, 30, 40 cents on the dollar. When the fact of the matter is that all that must be satisfied is delinquent taxes. And when the bond issue is brought current, the bond then continues. The property owner will then be billed over the life of the issue. So it is not unlike a bankruptcy proceeding, where you're going to have a settlement. And I think we've seen in some of the reporting why people will only get 10 or 20 cents on the dollar. I think the unfairness in some of this reporting is that right after it, why we didn't buy any--we didn't sell any, by the way--but we let the street know that we would buy if there were enough in size. But there were some odd lots, or small size, that I'm told traded around a 9 level. And that's a shame. Somebody sold that bond--knee-jerk reaction based on that article. So somebody took a loss that I... those bonds were definitely not... worth a lot more than that. But knee jerk reaction; they were frightened. Read about junk bonds, read all about the problems in the corporate field, and I don't think that some people that write these articles take into mind that they are costing some people money. Now, good reporting none of us have any objection to... Accurate reporting...

By and large, we, ourselves, every issue we have bought we have an onsite visit. I realize all investors can't do that, but we do. We interview the developer. So we do have an in-depth investigation of every issue we buy. Obviously, we've bought roughly 25 percent of the issues issued. Why didn't we buy the other 75 percent? Probably for various reasons. Some we didn't quite care for. I think the majority of the ones we didn't buy was probably more on price. We had disagreements as to how the underwriter was pricing them. I would think that would be the major cause of our turndown of an issue. Some we did turn down. They didn't meet our credit qualifications.

Obviously, the second question, could the growing wariness of investors toward the Mello-Roos bonds jeopardize the ability of local governments to issue bonds in the future?

Well, yes, because with this type of publicity, unless we get the word out just what a Mello-Roos bond truly is, why, the local governments are going to have to pay a higher interest rate. It's going to take a high interest rate to sell, to market the bond. As an investor, maybe I like that but it certainly puts a burden on the property owner, unnecessarily so.

What type of actions might local governments take?

Well, I think I mentioned a few here as mainly keeping us up to date on issues that are outstanding, which we have found very difficult on occasion to get. The information has been difficult.

What legislation should be enacted?

Well, I think another gentleman made the statement, and I quite agree with him, "if it ain't broke, don't fix it." I think by and large the Mello-Roos is a good vehicle. Maybe it needs some fine tuning, but basically the Mello-Roos... I think we are effective...We own as much as we do... Certainly, we have full faith and confidence in the Mello-Roos issue. Thank you.

Brown: Thank you very much, Mr. Harrington. I would just note for the record that we have a total of $3.6 billion in Mello-Roos bonds outstanding. That have been sold: 288 issues, not... I think you said $350 million. So it is just a much greater magnitude. You have some more you can buy! Right? You bought 90 out of $3.6 billion. $900 million. Good.

Harrington: $900 million, yes. I just left the zero off both sides, but the percentage is the same.

Brown: I take pride in watching out for zeros. Your zeros and mine line up.

Harrington: You know I do.

Brown: Okay. Thank you so much, Mr. Harrington. If there are no questions, we'll go to our next speaker who is Steve Zimmermann from Standard & Poor's. Is Mr. Zimmermann here? This gives you the rating agency perspective.

Zimmermann: Good morning. Thank you for inviting me to testify. I'm here on behalf of Standard & Poor's. Our perspective on the Mello-Roos market... First of all, I'd like to say I think based on the information that we have and the discussions that we have had, it's S&P's opinion that the majority of Mello-Roos bonds that are not rated are of non-investment grade quality. This does not mean, of course, that some issues structured correctly cannot become investment grade securities. This is an enormous market. And it's one, however, with a very limited disclosure. And I think it serves no one's purpose, not suggesting that all debt needs to be investment grade, but I think people should be aware of the risk of their investments and the exposure of the funds they hold. The corporate market readily accepts speculative grade securities, those rated double-B, triple-C, double-C. These securities may be appropriate investments for investors for whom timeliness is not such an important factor, timeliness of payment. And as a matter of fact, I think it's fair to say that most double-B bonds probably wouldn't default.

When we rate securities it's a fairly large universe that we have to compare to. It's the whole universe of debt. And therefore a good Mello-Roos bond may be equivalent to a strong general obligation bond. But many others may not be equivalent at all, and may never be equivalent due to size, legal structure, underlining economic base. Rating these issues is a complex process. And it's important to realize that value to lien is a very limited measure and it shouldn't be used as a proxy for investment grade rating.

You'd asked us in the questions that you gave us ahead of time to talk about the definition of overlapping debt. Well, our definition of overlapping debt is general fund obligations of overlapping taxing jurisdictions. We do not include revenue bonds that are self-supporting in the overlapping tax calculation.

The other question was what is the result of excess levels of overlapping debt. Well, excess levels of overlapping debt create strain on a household's ability to pay for existing debt and for municipal services. Mello-Roos carries with it its own tax. Other types of special district debt, like TABs can actually tap into the millage rate, and over-issuance there can actually drain off monies from the general fund, and I'd cite, as an example, the City of Fontana. We actually lowered the rating on their certificates of participation and the general fund actually suffered, while the TAB districts flourished because they actually took away the revenue from the City's general fund.

In talking about the discussions that we've heard in the media, I think as far as S&P is concerned, we've never said that the City of Oceanside is going to default on their Mello-Roos issue. I'd actually like to credit them because they knew that there were problems, and they stepped in and they had the ability and the wherewithal to help. I would have to say, however, that not every district may be so fortunate.

I think one thing, as far as recommendation for the future, there needs to be more information available on an ongoing basis after the sale of these issues. If we at S&P have difficulty getting information on the issues we rate, you can imagine the difficulty of getting information by the individual investor. I would like to submit to you a list of information that we require when we rate these issues, and perhaps that would give you an idea of some of the information that may be worthwhile in collecting.

I think it's also important... 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. Perhaps, if you were requiring an annual audit, or perhaps key information be reported from these districts and that way it would be in the public domain. People would have the advantage of being able to access it.

In conclusion, I'd like to say I think this market contains some very strong investment grade credits and some very weak, non-investment grade credits, but without information people don't have the opportunity to know which is which. Thank you.

Brown: Thank you very much, Mr. Zimmermann. Questions? Then we'll move to the next speaker from Moody's Investors Service, David Ambler. Mr. Ambler. What is it that makes people go to the right microphone or the left microphone? Is there something...?

Ambler: Right down the middle. Is this effective? I'm David Ambler with Moody's Investors Service. And I'd like to thank you for this opportunity to make a presentation. I will try to be as succinct as possible and edit my notes somewhat to do so. I'll also, as a starting point for my discussion, mention that it is true that most of the Mello-Roos bonds are not seen as investment grade by Moody's Investors Service. There are a few fundamental reasons I'll just run through. There tends to be--and I'm just talking about this since there primarily tends to be this raw land Mello-Roos sales--there are usually too few taxpayers which have issues of diversity. It also, we find those few taxpayers, it is difficult, as was mentioned earlier, to obtain financial information on them. And also, the issue of this handful of taxpayers basically making decisions as to the fate of future taxpayers. And it's always a hard thing to analytically predict what the reaction will be, but I think some of the comments today suggest there is some room for problems there.

And then underlying, there is the issue of that debt related to the value of the property. That we are looking at transactions that can be fairly highly leveraged. On the flip side, and it also must be mentioned just to try to be fair in presentation, there's been very, very few cases, at this point in time, of any problems of Mello-Roos debt. However, as has been stated, the current situation in the real estate market in California, and certain media attention to the issue, has focused a fair amount of attention on the issue.

The questions that were posed to me... It seems that in some ways you wanted me to cover the concept of overlapping debt. And it seems in some ways you would like me to discuss the issues of not the Mello-Roos district itself but the potential impact of a Mello-Roos district affecting some other jurisdiction that it overlaps with. Steve Zimmermann, prior, has already given us the definition of overlapping debt which pretty much holds industrywide. So what I will discuss after that is pretty much the concept of, basically, does it have a serious impact of credit quality in California? To date, because California has so many restrictions, as is, with issuance of debt, I must admit it's only a handful of entities where overlapping at this point in time has become a credit problem. It certainly is something to keep one's eye on, but I also have to be honest. There are very few credits that we have looked at where the issue of overlapping debt has been a large issue and has impacted credit quality.

On the other hand, many of the Mello-Roos districts, or many of them, do overlap with entities that are not rated. And, also (I think this might be helpful for you to get some sense of how much of the Mello-Roos market is rated and is not rated), as a percentage of volume last year, my company rated 89 percent of municipal bonds in the marketplace. And so if Mello-Roos bonds, and I don't know the total percentage of rated debt there, but it's still--even the numbers being discussed as far as rated debt--are a small percentage relative to their peer group, so to speak, of municipal debt. So, I'm basically saying nine out of every ten dollars is rated by Moody's Investors Service. And so the fraction mentioned before is a minority which doesn't mean that there's a problem, but there definitely is. They have not been reviewed by our rating agency.

Beyond that, and trying to move quickly, I thought what I would mention is some areas that I do see problems, and basically some recommendations of, or maybe questions of, places that you might want to investigate. One place that's been of concern in dealing with issuers is what I would kind of call a shopping syndrome by developers pursuing a Mello-Roos financing. It is very common for a school district in essence to lend its name to be the vehicle by which Mello-Roos debt is issued. And it is not uncommon, through some discussions with school districts and with overlapping entities, to find that they were not the first approached entity. And that one has worked their way down from a more sophisticated entity--and this is not meant in any way to belittle a school district, but I mean sophistication as far as availability of staff, and also basically that a larger municipality or a city may have those on staff who might be in a better position to assess an option being offered in front of them by a developer--but I find it's of interest to me that you can basically shop around and basically find the vehicle you want and that...

Brown: It may be that the school district is more desperate than other organizations because they don't have fee-generating ability which the other entities do.

Ambler: Well, there's two issues at hand. The school district would be more desperate because there's a lot of pent-up capital need. And school districts certainly are in need so you could say they're somewhat hungry. On the other hand, and it's a point of question analytically, is the question of whether they're in a stronger position to basically evaluate the proposal. And that's one thing I leave to you as a question for investigation.

The other thing which I'll hit here cause everyone seems to be asked this--the two-thirds vote issue going down to a majority vote. Certainly, credit-wise for most localities in California it would certainly have positive credit impact. G.O. bonds are seen as some of the strongest obligations. It would relieve some of the pressures that are on municipalities who tend to use leases. But I also want to point out to you that it seems to me with all the pent-up capital needs in California, one must recognize that the window of opportunity for G.O. bonds is somewhat limited. And given politics and the power of a local vote, I suspect most G.O. potential will go to school districts. And I realize what's in front of the legislative body does address school district needs, but it does leave the other pent-up capital needs of other districts kind of more in question. And they tend to be, I think, some of the more difficult issues because they tend to be more of the general benefit issues and how to deal with those. So I just point that as a question as one investigates this to, I think, school districts might be in a category of their own, and there may be relief for them, but one has to address other entities.

The final issue, which I find curious on a macro basis, is a lot of good suggestions have been posed. There's been thoughts of letters of credit, suggestions of possibly looking to the insurance industry to deal with some of the short-term potential credit problems for Mello-Roos bonds. But what I find curious, which I think is a question that should be addressed by CDAC is basically the "why". Why can one not receive a letter of credit from a bank? Why would a private insurance industry not be interested in providing the vehicle by which to go through the higher risk credit period in the short-term? Now there could be answers that may not be totally credit issues. But it seems those are definitely worthy of investigation because the issue is the cost of money. In part, a function of it is credit, and the determination is where is the credit risk being displaced or not. And those discrepancies are something that CDAC might additionally want to be involved in analyzing. As to why public entities are being looked to as the vehicle where it seems in many cases private entities are not interested in lending the money. And I pose these all as questions which, to be honest, I have not had the opportunity to explore since we rate so little of the market. But they leave me curious because they do not exist in other municipal markets for other bonds. And I thank you.

Brown: Very good. Thank you very much, Mr. Ambler. Are there questions from the Commission members? Our next and second to last agenda speaker, before we turn to public speakers--and I think we have still just one--I would invite Mr. Mann of *California Municipal Bond Advisor* to address us. Welcome, Mr. Mann.

Mann: Good afternoon to you all. My name is Zane Mann. I'm the publisher of the *California Municipal Bond Advisor.* It's an investment newsletter directed toward individual owners of California municipal bonds. Coming as I do at the end of this long discussion I'm really going to sum up or emphasize those points that have been raised that certainly affect individual owners of municipal bonds.

To begin with there is no question but what the chicken little, henny-penny articles that have been appearing on financial pages have indeed concerned the individual owners. As Greg Harrington pointed out, there have been panic sales of Mello-Roos bonds that have cost the investors a considerable sum of money, and unnecessarily so, as far as I'm concerned. There has been an effect, in addition, from the issuer's point of view, since certainly the interest cost of a new issue of Mello-Roos today is quite a bit more than it was six or eight months ago. Roughly, I would say interest rates on Mello-Roos bonds are up about a full percentage point over the past year, and this is in the face of, as we all know, a declining interest rate environment where interest rates for the state, let us say, have been reduced by a half point. So we're talking about possibly as much as a point and a half differential, most of it--I don't want to say most of it--a portion of it, as a result of the bad publicity. On the other hand, let us not be too complacent. There are some very good reasons why there is concern in the Mello-Roos market. And it is indeed the real estate recession that's going on in the state.

I would like to go over, as I say, mainly to emphasize some of the points that have been raised here and to indicate the concerns that individual investors have. Certainly, if the individual investor could attend a meeting like this, and in fact hear Ms. Walsh's presentation, their concerns would be put aside to some extent. In fact, I would suggest that her address be put on the front page of the Orange County Mello-Roos prospectuses. That is not... Her point of view, or Orange County's point of view, is not universal. Far, far too many local governments consider the Mello-Roos financing as a form of conduit financing. Yes, we put our name on it, but we have absolutely no responsibilities. If you want to find out something call the contractor. And, by the way, when you call the contractor you can't find out anything either.

What we need more than anything... What the individual investor needs more than anything else is disclosure. We have to have access to information. I'm going to turn to that in just a minute. I noted that many of the speakers refer to this lien-to-asset valuations. And we have this magic number of 3:1, and that's supposed to make everything fine. The fact of the matter is who establishes the value of the asset--the land.

I have deep suspicion of MAI appraisals. Every bond issue I know of that is in default has a marvelous MAI appraisal. I did write down for the committee two bond issues that have been in default and are about to have their default cured. One is a $9.7 million Long Beach office building. The appraisal was about 125 percent. The new appraisal for the resale is $2 million. In some way we got from $10 million to $2 million. And the bond holders will receive about 19 cents on the dollar after all the fees. The other one is the L.A. Garfield Building COP that went bankrupt six or eight months ago. That had a $9.3 million appraisal and the sale is for $2.2 million. So that we can't simply say, "oh, everything's going to be alright" because we've got an appraisal here that is three times the debt as represented by the bonds.

I also would emphasize and I thought Dave was going to--I'm going to be meaner than Dave. This business of school districts putting their name on Mello-Roos bonds, whose major purpose is to finance land development, I believe, actually should be outlawed. When you see a school district bond issue, the impression certainly is that it's to finance school buildings. And when we vote for school board members, we vote for them. Their purpose is to educate our children, to hire teachers, to establish curriculum, to build buildings. I'm not so sure that they're authorities on real estate development. The famous Temecula default; it was $27+ million, I think, of which $2 million went to build schools. 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. And that is of deep concern, I think, to the individual. Remember, the individual, even though they should, does not have the opportunity, does not read his prospectus, number one, certainly not all of it, and does not have the opportunity that Franklin Fund, or the resources that Franklin Fund has, to investigate the bond issue.

One of your questions to me was: Will this continuing difficulty with Mello-Roos bonds cause the market to dry up? The answer is "no" because you have people like Greg Harrington and the other fund managers who have the resources to go out, look at the land, talk to the developer, talk to the contractor, and follow up on the bond issue. The individual cannot do that, and in fact it is our advice that until the real estate recession is over that he not buy Mello-Roos bonds unless he has some secondary information that's not normally available. But thanks to the funds there will be a continuing market for Mello-Roos bonds.

I was interested in Orange County's and Riverside County's use of letter of credit and then the suggestion by the Commission of the possibility of insurance. If indeed the state could establish a revolving fund insurance such as the one used for health facilities

Brown: Cal Mortgage.

Mann: Yes. That would be most valuable. And one of the greatest reasons that I would endorse it is because I know that the state would not insure until it had carefully investigated the project. Just as they do with health facilities. That reassurance alone would make the bonds more marketable.

Brown: It would add additional costs as the speakers...

Mann: Yes. But well worth it as I'm sure as individual investors do today, when we buy insured bonds we know that the premium for that insurance comes out of our yield. And there's no objection to that.

I had one last point and then I am through. I wanted to call the Commission's attention to the fact that the State of Colorado as of January 1 has passed legislation requiring full disclosure on their special district bonds. And for the most... I have various portions of the law, but it's not necessary to repeat it. It simply requires that the local issuer, the local governmental body that issues the bonds, must make annual reports not only on tax collections, but on buildout, on rate of delinquency--all of the things that the analyst wants to look at when he makes a judgment as to the security of the bond issue.

Brown: Very good. Questions for Mr. Mann? Thank you for coming, Mr. Mann. Carla Stallings is here on behalf of Harry Clark. Ms. Stallings. Please begin and state your name for the record.

Stalling: My name is Carla Stalling. I'm with Muni Financial Services, and here on behalf of Harry Clark. I'd first like to commend Stephen Shea and CDAC for preparing a fabulous report on Mello-Roos. And I believe that report may have some of the best recommendations for Mello-Roos yet published. Mello-Roos would be greatly improved if many of the policy recommendations included in the report were adopted within the industry.

Mello-Roos bond issues have been recently spotlighted in a number of publications. Much of the negative press was brought on by the unfortunate seizure of Executive Life Insurance Company assets and its effect on the Temecula Valley Unified School District bond issue. The reality is that bond holders are secure, and California has experienced considerable economic expansion since the implementation of Mello-Roos funding.

Your question is: Are bond holders secure? For Mello-Roos bonds, investors are secure because of the built-in mechanisms for meeting debt service, most importantly, the reserve fund and the value-to-lien ratio. The reserve fund is a portion of the bond proceeds set aside upon issuance to cure any delinquencies which may occur. This ensures, on a short-term basis, that bond holders will receive interest payments. Typically, the reserve fund is up to 10 percent of the outstanding bond issue amount, and the replenishment of the reserve fund, in the event of its drawdown, is often provided for and calculated in a yearly special tax requirement. Investors are further secured by the fact that collateral for the bonds is the real property itself. In the appraisal, the value of the land and improvements is generally required to be at least three times as great as a proposed bond issue amount. This means in effect that a development with an appraised value of $3 million can issue up to $1 million in Mello-Roos bonds. Taking this further, the $1 million issue has an annual tax levied of about $100,000 a year. If a developer doesn't pay any tax in one year, the reserve fund would be used to meet the debt service payment. At this point the issuing agency would initiate foreclosure pursuant to a typical bond covenant.

During the second year, a default may occur, assuming the agency does not feel pressure to cure the delinquency with a transference from agency funds. However, the second year's tax payment for the developer would again equal approximately $100,000, making the outstanding special tax obligation about $200,000. As foreclosure proceedings continue, it becomes apparent that the property initially valued at $3 million dollars will be sold for $200,000 plus delinquent taxes and penalties and legal costs.

Perhaps the most unfortunate thing which has happened since the beginning uses of community facilities districts is bias placed on the financing tool by developer influence. Many professionals knowledgeable in the community facilities district arena have a developer background. This has resulted in the creation of special tax formulas which are biased toward the developer, shifting the burden to the future homeowners and the public agencies. In fact, most CFDs issued have been biased toward the developer. Furthermore, Mello-Roos has effectively increased profits for many developers. Most developers will agree--behind closed doors--that the market determines the price of the house, and the price determines the developer's profit. The lower the developer's cost, the higher the profit to the developers. In effect these two mechanisms--profit and no taxes--translate to benefit the developer. Mello-Roos funding is attractive to developers.

All developments require the installation of infrastructure, including roads, curbs, gutter, water and storm drains. The developer has three ways to fund this infrastructure: cash in the bank, loan from a bank, or tax-exempt financing by either Mello-Roos or assessment district. With either cash or bank loan, the cost of the infrastructure will be deducted from the profits of the house directly to repay the investment. However, with assessment and Mello-Roos, the cost of the infrastructure is turned into profit because the repayment is made by future property owners over 25 years. And typically the price of the house is not reduced accordingly. This allows once again for increased profit for most developers.

Mello-Roos has been more popular than assessment districts for developers because Mello-Roos allows a tax burden to be shifted from undeveloped land to developed land. Assessment districts strictly prohibit such shift in tax burden. All property owners are to pay their fair share of the debt. Muni Financial Services Inc., as administrators of hundreds of assessment and Mello-Roos districts throughout the State of California, sees Mellos where the first year of tax payment is paid by capitalized interest from the bond issue, and the second year tax is shifted to the minority of the property that has developed. The result is a developer that has authorized and benefitted from tens of millions of dollars of tax-exempt financing, and increased profits without any cost whatsoever.

We believe also that many projects have been issued which should not have. A major motivator for the issuance of certain Mello-Roos was greed by many of the parties involved. We recommend that an investigation be conducted into certain issues including that of the Temecula Valley Unified School District.

In conclusion, the community facilities districts benefits cities and residents. They are secure investments. They improve the quality of life for many residents and attract businesses to a community. Businesses provide jobs which help to bring about healthy economic conditions within a city, which again secures bond holders' investments. Community facilities districts have been victimized by lack of foresight and haste. What should be a useful funding tool for cities and property owners has turned into a huge misunderstanding between property owners, developers, bond holders, professionals and city officials. This misunderstanding could serve to undermine the very objective of the Mello-Roos laws, mainly to enhance California's economic growth and security. The negative press surrounding Mello-Roos has been good for California. By establishing policy standards for Mello-Roos as outlined by CDAC, by requiring special tax formulas to be fair, and finally with indentures and tax formulas working together to attract investors, California administrators can learn from these issues so that it may continue to have a viable economy.

Brown: Thank you very much, Ms. Stalling. Are there any questions from the Commission members. Hearing none, we do appreciate your testimony and appreciate your attendance today. Our final speaker then on our agenda is Dean Mysczinski of the California Research Bureau. Mr. Mysczinski. Welcome. What made you come to that mike?

Mysczinski: Thank you. I'm aware of the tension here. Well, I thought what I'd do is spend half of my time at this one and then move over. Is that alright?

Brown: That's two and a half, and two and a half.

Mysczinski: I would like to start by thanking the Commission, and particularly the Chair, for conducting what has been an astoundingly constructive and thoughtful and rational hearing on what could well have been a much more sensational subject. And it's not only commendable but remarkable that you were able to do that--although it's not over.

Mysczinski: The most useful thing that I can do in a few minutes, I think, is first of all to say that Mello-Roos didn't happen all at once. It happened over ten years of constant legislative revision. And that's going to continue, partially in response to the current controversy, partially in response to the first experience that we've had with Mello-Roos in the depths of a recession. Senator Mello asked that I prepare a draft of a bill that he plans to carry, another cleanup bill, and to address a lot of the issues that were talked about today. And as you well know, the deadline for getting the bill to Legislative Counsel is Friday of this week and so I have two days to write. I thought the most useful thing I could do would be to run through the list that I now have of possible proposals. And I cannot say that Senator Mello will agree to do these, any or all, but they're the agenda as I know it right now.

One is that there are a number of things having to do with notice to homebuyers, notice to the secondary buyers as well as the first buyers:

- The notion that the notice should be given out earlier, possibly at the time that the offer is signed or time of purchase;
- That the current exemption in cases where a DRE White Report is given should be eliminated;
- Possibly the law should go so far as to spell out word for word what the format of the disclosure should be, so that there is no room for local attorneys to contrive artful and confusing wording--at least more artful and confusing than the Legislature might do.

Second, it doesn't really help to disclose if the tax formula is so complicated that no one who doesn't spend full time working on this can understand it. It might be that it would be a good idea to require:

- That where residences are being taxed that the formula be simplified;
- That it not exceed 1 percent of value;
- That the escalation factor not exceed two percent a year;
- That what the money be used for would be clearly specified in some form.

The intent of current law is that these things would be spelled out quite clearly but it is always done, I know.

A third possibility, partially in response to Harry Clark's complaint, is that there probably have been some abuses of this capitalizing of interest for two years, and there should probably be some limits on capitalizing of interest.

Four, there is a complaint made by some of the taxpayers that major changes were made in the use of money after people had moved in. Now, I thought that was illegal. And I think we need to find out how that occurs. And make sure that it's illegal. Because that shouldn't happen. They're supposed to setup the district and specify the uses and then that's that and not to be changed without a vote.

There is a problem which has not been talked about today with the use of Mello-Roos districts in conjunction with Marks-Roos districts that I think needs some time and attention, and perhaps you'll get to it in your other projects.

There is a problem with what I call subsidiary districts, such as school districts being the fronts for developer-structured Mello-Rooses. It does no good if Orange County or Riverside County are terribly sophisticated and have good policies if the developers can go to the local water district or mosquito abatement district and have them set up the district. Now I proposed language last year that would have changed that and made that unlawful, and I heard a lot of complaints from school districts who said essentially, "Look, we're poor; we have no money. This is the only way we've got to come up with some money. Leave us alone!" And since last year nobody cared but me and we left it alone. But it may be that this year will be different. At least it's worth thinking about.

It might be that the law ought to specify something about the value-to-lien requirements, that there should be a finding of a minimum of 3:1 or some ratio. It might be that the law ought to specify the assumption used in the appraisal process. Now that isn't going to solve the appraisal problem of appraisers are funny people (no offense), but they deal in an art not a science. But we could at least specify the basic assumptions.

A proposal that was made here today that I don't think seriously ought to be on the list is this notion that there should be a state commission empowered to review all Mello-Rooses before they were issued. I don't think that's realistic. I don't think the scale of problems we've seen justifies that; although it's open for discussion of course.

I would perhaps, as an aside, say that one of the most persistent problems and confusing problems in the state has to do with the Tracy district and what happened there. And it might be that the Commission would care to direct its staff to undertake some inquiry into Tracy and into the peculiar problems of how school kids were assigned away from the Mello-Roos district. And make some recommendations. As I've never had the time to do that, and there is clearly something that happened there.

There was a suggestion that appraisals and absorption studies be done by people who work independently of the developer. It's not in truth easy to do that. But we could perhaps find words that would at least say that. As you know, there's been a debate in Los Angeles about a similar provision and it's not easy.

There was a proposal that the State ought to guarantee, in some form or other, Mello-Rooses. I confess I think that's a little crazy. The State's not going to do that. We cannot do it analogously to the way we guarantee hospital funds without a change in the State's Constitution. And I think that's probably not likely to happen. It would be fine if it could.

I think that's basically my list, which is a little disorganized. Oh!--there were proposals that we should specify more clearly what ought to be on official statement type of disclosure. Disclosure to investors and bond buyers. And although that's not normally thought of as the province of state law, but rather federal law, it may be that we should do something like that.

And then finally, we almost certainly need better secondary market disclosure. And there was language added to the law last year which encouraged secondary market disclosure, but on a voluntary basis--and there was opposition going farther than that. And a most interesting question, perhaps, for this group is if we were to require that cities report regularly on the condition of their Mello-Roos districts, the question arises to whom should they report? And the most obvious repository is right before us. And I don't know whether that would make you nervous or not. But you might think about it. It might make other people nervous, I promise you.

That's my basic list. One other request as long as... maybe I could make is... With respect to improving disclosure the law currently requires extensive disclosure, but no one has ever collected the disclosure forms that are actually used by local agencies. If the Commission staff could do that and collect 50 or 60 different forms, we would then know a good deal more about what is currently going on and also have probably a better basis for drafting some sort of collective form.

That's my list. I read the list in part because I thought it would test my hearing and see if I had missed anything.

Brown: You did just fine. Mr. Mysczinski, thank you. Senator Bergeson has a question.

Bergeson: Mr. Mysczinski, one of the concerns indicated by one of the witnesses was whether or not there would be changes in assessment. Say, with declining values within the residents or within the project, or whatever. And I was wondering if there is or if there has been any attention given to provisions for declining value. You mention appraisal but what about re-appraisal as we see changing economic situations. And also the buildout within those communities that was predicated upon a presumption of revenue and whether that would materialize. Whether that again would impact those homebuyers. I guess it's kind of a multi-faceted question as to really where is the taxpayer going to end up with changing conditions, whether it be a changing economy or whether it be a revenue stream that fails to materialize.

Mysczinski: Well, the way I understand it, at least the first part of that concerns what Mr. Taussig called "coverage". The extent to which the tax levied against residences can be sufficient to cover the debt service plus 10 percent or some other amount sufficient to cover disasters, particularly the disaster that the developer goes bankrupt. The current law does not set a limit on the amount of coverage. In theory it's possible for a bond attorney to set up one of these districts so that if the developer failed, the tax on the homeowner could double or triple or quadruple. I've never heard of that happening but it could legally happen. And maybe there ought to be some statutory limit on that. The other way at looking at the question is, people talk about Mello-Roos bonds as though they were one kind of thing, but in truth they're two completely different kinds of things. There is a relatively high-risk bond for a relatively short period of time when the project is developing. Once the project is developed, in my view, most Mello-Roos bonds are almost like G.O.'s. There's a widely distributed tax base, and they're remarkably secure. By now, a fair amount of the $3.6 billion of debt is in the second category. And it's that first part that's the danger and that we need to be careful about, and where we particularly need secondary market reporting. Which is another way of getting at the point that you're making. If there's been evidence of a major drop in land values, something like that ought to be reported so that the world at large knew about it--not just some investors who were able to unload their bonds. Not that anybody would do that...

Brown: Further questions, Senator?

Bergeson: Lots of them. But I'll save them for later.

Brown: Thank you very much, Mr. Mysczinski. Our one public speaker is Donald Swift from Aliso Viejo. Mr. Swift. We might have another one?

Swift: Madam Chairwoman. Senator and Commissioners. My name is Donald Swift. I live in Aliso Viejo. And in the past few months I have undergone quite a bit, taken a lot of time, to study Mello-Roos taxing in our district, which is CFD #88-1.

When I looked at the agenda I was a bit disappointed that there were so few taxpayers. And I have a feeling there are very few taxpayers here.

Brown: I think we all pay taxes. At least I do.

Swift: I mean Mello-Roos taxpayers. Excuse me.

Brown: Mello-Roos taxpayers. Yes, you could be correct.

Swift: But there are lots of developers, county people, bond consultants, bond underwriters, bond funds, market absorption analysis--and they love Mello-Rooses because they all live off them. They all make a lot of money off of those. But the taxpayers--the ones that are paying these taxes--they're at work today. And they're having to struggle because these taxes are, in many cases, not fair. And I want to give you an example, when we come to tax rates, what our rates are in Aliso Viejo, CFD #88-1. Now the developers are not amiss to putting in 30 homes per acre. Now 30 homes--the average Mello-Roos tax rate is close to $30,000. The developer's tax rate at the first level is $600 an acre. That's two percent. And it may not ever go beyond the first level of taxation to step two. If it goes to step two he may pay $700; he may pay $1,000. And the most he can pay is $12,000 an acre. This is almost one third of what the developed property is going to pay. Now I ask you not to have any tears for the developer that's stuck with land in a Mello-Roos. Not on those rates. And moreover, it is important to know that the developer, even though he may not be selling his land as fast, has other means of getting rid of this land. Much of it is dedicated to the County. That's out of his inventory. Much of it is dedicated to our master association. Out of the inventory. And in one of the projections for our Mello-Roos, the developer is out of land in about four or five years. And the load goes solely to the developed property, and in that projection the total debt service paid by the developer was somewhere in the area of 3 percent.

Now as far disclosure is concerned. Of course, the buyer needs to be told of the Mello-Roos. The resale buyer needs to know it. But now we're worrying about the bond investor. He must be disclosed. No one has said anything about disclosing to the taxpayer, who pays year after year after year. He gets absolutely nothing from the legislative body that is administering his Mello-Roos that he pays thousands of dollars for. He has no idea how the funds are invested. He has no idea who's paying what taxes. How much is the developer paying? How much is the commercial paying? And I recommend seriously that although a constitutional amendment, I think, is one I would support, the time lag for that calls for immediate addressing the reporting of Mello-Roos conditions to the taxpayers that pay the bills. And this would include a fiscal year income and expense statement, a fiscal year audited financial statement, fiscal year report of tax receipts from each of the following classes, and on and on. Things that they need to know. They can evaluate. They're smart. They just don't have time to go to the County and get all that information. And when you go to the County you don't get much. They say, "well, our bond consultant handles this." I called the bond consultant. I said how much did the developer pay in Mello-Roos taxes last year. "That's confidential information." We're in the dark!

Now, there are some provisions, and I'll finish up with this. There are some provisions in the Mello-Roos Act for protest by taxpayers and registered voters. Once a certain percentage vote for changes in the bond issues, or facilities to be built by the bond issues, that has to be considered by the Legislature. Now it's come to my knowledge that in land sales contracts in Aliso Viejo the buyer is having to sign waiver of his rights to protest. That doesn't sound right. And I don't have something in front of me to show to you. But it's something that I would ask the Commission to look into. Because if the teeth is out of the Act, then we're at the mercy of a plan that goes on for 50 years, 60 years, with no recourse.

Brown: Mr. Swift, thank you very much. Are there questions from the Commission members? And we did make note of your question and we will be happy to investigate that. The final speaker is Roger Rossbold, a real property consultant from Laguna Hills. We are going to end precisely at 1:30 p.m. if you keep to your time.

Rossbold: I've got five minutes. The rest is up to you. Thank you. I am a real property consultant. My practice focuses on fiscal impact analysis, including annexation of projects as large as 4,000 acres. I also do market feasibility analysis of residential and commercial development. In addition to that, I am privileged to serve as Finance Commissioner for the City of Irvine. And prior to that I was a Community Services Commissioner, taking the lead on a $60 million Mello-Roos facilities district for parks for the City of Irvine. We were defeated by a three-to-one margin. So with the Finance Commission giving me a perspective on the problems of city financing and local financing, what I'd like to do is address three issues that have been covered today.

Number one, professionally I would recommend that developer-supported improvements to the land (road, sewer, water, power, etc.) not exceed one half of one percent of the assessed value of the property. That leaves us one percent for the basic tax levy and it leaves a half percent for future unanticipated costs which may accrue down the road, be they additional fire stations, police, public safety, parks or what have you. I think that's fair to homeowner and the future buyer. And I think from a market feasibility standpoint, it's sustainable in the market.

Secondly, I would not recommend support of ACA6--the first time I've heard about is today--which is a simple majority. A simple majority does not provide for a margin of error. We've heard Mr. Taussig today address debt-service coverage ratio. We've heard value-lien ratios. All of these things address the issue of a margin for error. If we talk about a simple majority, and given the fact that in some jurisdictions the majority of residents are not registered to vote--the majority of registered voters don't turn up to vote--we have the possibility the way some propositions are written by George Orwell and Alice in Wonderland that "yes" is "no", and "no" is "yes". I think there's the element of confusion on the part of the voter that a simple majority is not fair. I would recommend a minimum of 55 percent which allows for a 1.22 "yes" coverage vote ratio to cover for the margin of error.

Finally, I'm glad of what Ms. Stalling said today. I thought I was going to alone in mentioning this. But in a free market the buyer/consumer sets the price, not the supplier/developer. When a developer says if you impose this cost I will pass it through to the buyer...hogwash. It affects profit; it affects the land value which the prior owner of the land assumed his land was worth, but it doesn't always get passed through to the buyer. Prices of homes in Orange County the last two years have dropped 25 percent in some areas. And I would challenge any developer to say that it's because assessments were reduced or the land value was reduced or whatever. The buyer dictated what they will pay for the home. So, yes, costs are an imposition and do ultimately affect the price of the home, but don't say it affects the affordability without also saying it affects profitability and the value of the land. Thank you.

Brown: Thank you very much. Are there any questions. If not, I would invite any of the Commission members and guests of the Commission to make any comments which they might have regarding the hearing today. Start to my right.

Merz: I think I'd just say that I feel this hearing was very worthwhile. I know I learned a lot as a County official and as a Commissioner. And that it really revealed a lot to me from the various perspectives here. And it will give us a lot of information that we needed in order to make these decisions. And I want to thank everybody that did come forward today because it really provided the information that we needed to make decisions. That's basically all I have to say.

Brown: Thank you very much, Treasurer Merz. Senator Bergeson.

Bergeson: Well, I'd like to thank the Commission for the opportunity to participate in the hearing. It was very informative and I would like to invite continuing dialogue of the Senate Local Government Committee which will be looking at these issues if there is legislation... And certainly we invite your continuing input and appreciate whatever support you can give to making it a truly democratic process.

Brown: Thank you very much. Treasurer Turner.

Turner: I'd just like to echo the comments that I think this has been a very informative presentation. And I'd like to thank Commissioner Brown for having the foresight to get this hearing going for this benefit. Thank you, again.

Brown: I would just conclude by summing up the issues that I heard. And they blend rather well with those that Dean Mysczinski identified.

We heard a great deal about the disclosure of the Mello-Roos tax to homebuyers and to taxpayers. We heard about disclosure in the secondary market. We heard, in addition, about limiting the burden of the Mello-Roos tax, and different suggestions were made relating to that. We heard about the vulnerability of Mello-Roos bonds to the recession and to declining real estate values. And we heard about the need for secondary market disclosure and disclosure to Mello-Roos taxpayers. We heard, in addition, about the vulnerability of local governments to unsavory developers and underwriters. And we heard about the so-called "shopping" for a Mello-Roos sponsor, and heard a good deal about that. We heard some requests, though we also heard objections to, possible state regulatory action, such as a state review committee. And we heard about greater representation of taxpayers on Mello-Roos boards at the local level. We heard about the notion of equity over and over and over again.

I think if there is one theme that came through, we heard a lot of technical information. We heard a lot of very informative presentations that related to the range of the issues that confront us as we look at Mello-Roos bonds. But I think if there is one underlying theme, it is that this question of fairness and equity. Which brings me to the final issue raised that Dean did not have on his list, and that is the G.O. bond measure and changing from a two-thirds vote requirement to a simple majority, or as suggested by our final speaker, something in between. But who benefits and how they benefit and how they pay for the benefits of living in a society and in a community is fundamental to the whole Mello-Roos Bond Act.

I would like to conclude by thanking my Commissioners and thanking Senator Bergeson for her attention, her time and her presence here. It really does, I think, enhance the deliberations of the Commission. And I especially want to thank Steve Shea and Steve Juarez, the Executive Staff for the Commission who have really put together an outstanding framework for this hearing so that we could generate as much information, as much light, and the heat we were prepared to take. And I want to thank them. Is there anyone else from the staff that is here, Steve? And Mary as well. Thank you very much.

It has been my pleasure to hear from all of you today. And we will, as a Commission, review the testimony. And we will make a report to the Legislature, Senator Bergeson, and will do so in a timely manner. Thank you all for your time, for your attention, for your patience. Good day.

Section II

Written Testimony

Public Hearing

On The

Mello Roos Act

California Debt Advisory Commission

Santa Ana, California
January 15, 1992

SECTION II

WRITTEN TESTIMONY

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The following persons presented both oral and written testimony at the hearing. Their oral testimony is included in *Section I, Oral Testimony*, and their written testimony is on file with the Commission.

Donald C. Swift, Aliso Viejo Community Association
David A. Doomey, Director, Facilties Funding Administration, Capistrano Unified School District
David Celestin, President, Orange County Building Industry Association
David E. Booher, California Council for Environmental and Economic Balance
Steve Zimmermann, Managing Director, Standard & Poor's Corp.
Eileen Walsh, Administrative Officer, Orange County
Anthony Wetherbee, Chilton & O'Connor
Harry Clark, Muni Financial Services, Inc.
Mike Vail, State Chair, Coalition for Adequate School Housing
David Taussing, David Taussing & Associates, Inc.
Joe Evans, Empire Economics
Ursula H. Hyman, Latham & Watkins
Timothy J. Davis, Deputy County Counsel, Riverside County
Walter Heuck, Palmia Master Association

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CALIFORNIA DEBT ADVISORY COMMISSION

January 8, 1992

Steve Shea
California Debt Advisory Commission
P.O. Box 942809
Sacramento, CA 94209-0001

Re: Mello-Roos

Dear Steve:

This is just a follow-up to our telephone conversation of Wednesday morning.

Disclosure is an area that still needs strengthening in the law. I am enclosing a sample disclosure form that I am proposing to use in one of my projects now. I firmly believe that there should be a legal requirement for a developer to have such a form signed by a prospective purchaser <u>before</u> the prospective purchaser is permitted to sign even a <u>contract of purchase</u> on a home.

We might even go farther, and this is not something I mentioned in our telephone conversation. If a prospective home purchaser were required to make an election, at the time of purchase, either to pay off the entire special tax obligation in escrow or, as an alternative, to agree to accept the on-going tax, I believe this would go a long way toward forcing the presence of the tax to affect the purchase price (which is the <u>practical</u> measure of "fairness"). I enclose another form that attempts to accomplish this. I am also proposing to use this in one of my projects, although I have not had any experience in using it in the past.

The great difficulty in doing the payoff option, which is the reason why it has not often been done before, is that it can be very difficult to calculate a payoff amount. If we are trying to base the amount of payoff on the amount of the taxes that the home would otherwise pay in the future, it can become virtually impossible. That is, we do not yet know precisely what the construction cost will be, we do not know what inflation will be prior to the start of construction, we do not know what the absorption rate of the development will be so we do not know when the facilities will be built, we do not know what the interest rate will be when bonds are sold in the future, and if schools are involved, we certainly do not know what contributions will come from the State program. We would, therefore, have to make conservative assumptions on all those points which would mean that the payoff option would, in practice, be very expensive. It may, nonetheless, be worth doing because of the attention it draws to the presence of the tax at the time of purchase.

Another option of prepayment might be to reduce all infrastructure cost to a per house cost, and size the Mello-Roos as an appropriate multiple of that figure. That figure can perhaps be adjusted annually to reflect inflation, etc. The one-time payoff option in that amount can be given to each purchaser.

In either case, if a homeowner would later complain that he did not get anything for his tax, he can be told that he got a purchase price that was, in effect, lowered by the amount of the payoff option.

Again, a sign in real estate offices or on real estate purchase contracts, that is similar to the surgeon general's warnings on cigarettes but related to Mello-Roos, might be an appropriate legislative requirement.

Finally, I want to reiterate my strong belief, based on substantial experience, that there are many situations where it is not only appropriate, but a much better practice, to permit different tax rates on developed and undeveloped property. So long as this is done in a way such that the developed property does <u>not</u> subsidize the undeveloped property, it is both fair and a means to avoid potential explosive political problems.

To briefly remind you of the example I used in the telephone conversation: If the ultimate fair share for a house will be $1,000 in Mello-Roos tax, it is better to start charging that amount on each house in Phase I of the development from the beginning, even if the undeveloped Phase II pays a lesser amount initially. Phase I is paying its fair share; Phase II has less infrastructure than Phase I, so it pays less; and most important of all, when Phase II is built, the residents of Phase I will not see a sudden increase in their taxes. That is what is explosive.

Finally, in the case of schools, if property has been required to participate in a Mello-Roos because of the legislative authority to require it to mitigate its school impacts, then to require it to pay a tax before it <u>has</u> any school impacts may exceed the legislative mandate and actually be illegal. Note that if the property <u>never</u> develops, it will never have any school impacts and that, in any case, it has no school impacts <u>until</u> it develops.

Again, if there is any thought ever given to codifying your guideline on whether developed and undeveloped property should always pay the same rate, I would like to have an opportunity to testify on that issue.

I have also enclosed a form letter I have developed for governing boards which are experiencing protests from Mello-Roos taxpayers, in case it may be of interest to you.

I appreciate the time you took with me on the telephone on Wednesday morning and look forward to speaking with you again soon.

Very truly yours,

STURGIS, NESS, BRUNSELL & SPERRY
a professional corporation

Daniel C. Bort

DCB/aw
Enc.

Government
Financial
Strategies
inc.

January 9, 1992

Mr. Steve Juarez
Executive Director
California Debt Advisory Commission
915 Capitol Mall, Room 400
P.O. Box 942809
Sacramento, CA 94209-0001

Dear Mr. Juarez:

With regret, we are not able to attend the January 15, 1992 hearing which has been called by the Chair of the California Debt Advisory Commission, Ms. Kathleen Brown, to openly discuss the benefits and liabilities associated with the Mello-Roos Community Facilities Act of 1982, as amended (the "Act"). However, we wish to respond in writing to some of the aspects of the Act which have recently come under scrutiny.

We are a financial planning and advisory firm located in Sacramento. Our focus is facilities financing. We serve more than 50 local government agencies throughout the State, the majority of which are school districts. We view the Act as providing one of the only several available avenues local government agencies have to meet the growing infrastructure crisis in California. By our observation, Mello-Roos districts formed under the authority of the Act can be either one of two types: landowner voted (or land-based) districts or popularly approved districts.

Our company has had direct experience with the formation and utilization of five popularly approved Mello-Roos districts within the past two years with a combined bonding authorization of over $150 million. We view popularly approved Mello-Roos districts, from a public policy point of view, to be similar to a general obligation funding source in many ways. Both are approved by a vote of the people and require a two-thirds majority for passage. The Act, however, provides Mello-Roos funding districts with much more flexibility with respect to tax policy than a rigidly controlled ad valorem funding source. For instance, the ability to "custom design" the boundaries of a Mello-Roos funding district, the tax rates and taxing methodology which can be implemented and the ability to provide exemptions to certain residents of a Mello-Roos funding district are just a few of the many benefits which the Act provides. The added flexibilities of Mello-Roos districts which are authorized by the Act make them the only means by which numerous communities throughout the State can achieve a two-thirds majority vote.

Our experience with popularly approved Mello-Roos districts has been that the local government agencies which form them and the communities which the Mello-Roos districts serve have found the Act to provide them an extremely important and valuable means by which public infrastructure is funded.

On the other hand, I read with much interest a recent article which was published in the *Wall Street Journal* that described the risk of bond default in several Mello-Roos districts in California. Our philosophy with respect to Mello-Roos financings for schools (that are not popularly approved) is that the purpose of landowner approved Mello-Roos districts is to provide a means of growth mitigation. As such, the mitigation is not needed until the point of impact, which, of course, is just after the construction of new homes.

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Government
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November 25, 1991

Mr. Steve Juarez
Executive Director
California Debt Advisory Commission
915 Capitol Mall, Room 400
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When forming Mello-Roos districts which are land-owner approved (i.e. approved before the appearance of the homeowners), it is our strategy to design Mello-Roos school taxes which are levied only after the property is developed and after the homes have been constructed.

Consequently, we do not recommend that our clients issue Mello-Roos bonds secured by projected development. The Mello-Roos bonds that are issued by our clients are quite different than the Mello-Roos bonds described in the above referenced article. Those CFD's, and specifically the bonds that have been issued in conjunction with them, are in fact secured by future development under the theory that "if we sell the bonds and put in infrastructure, the people will come."

It is certainly the case that some infrastructure, if not a surefire growth inducement, is a precursor to development, such as roads which are required to gain access to a development site. However, we object to the issuance of debt which is to be repaid by projected development unless it is absolutely necessary, and then only if adequate protections are put in place.

On behalf of our clients, we need to be concerned about the negative publicity regarding Mello-Roos bonds because such negative publicity affects the capital markets and increases the likelihood that borrowing costs on future bonds, Mello-Roos or otherwise, issued by our clients will be higher.

When available, we would be interested in receiving an official transcript of the hearing, and, of course, if you would like to discuss any of this information with us further, please let us know.

Very truly yours,

GOVERNMENT FINANCIAL STRATEGIES

Paul E. Raineri,
Vice President

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"Preparing today's students to succeed in tomorrow's world."

January 14, 1992

Mr. Steve Juarez, Executive Director
California Debt Advisory Commission
915 Capitol Mall Room 400
Sacramento, CA 94209-0001

Dear Mr. Juarez:

The Saddleback Valley Unified School District (the "District") would like to take this opportunity to express our support for the Mello-Roos Community Facilities Act of 1982 (the "Act). The District was one of the first school districts in the state to utilize the provisions of the Act in order to provide funding for necessary school facilities when state construction funds were nonexistent or extremely limited. The District formed its first CFD under the Act in 1986, and since that time, has formed six additional CFDs for school facilities. In addition, the District has participated with the County of Orange under a Joint Financing Agreement for three additional CFDs.

As a result of our success with CFDs, the District has been able to complete the construction of two elementary schools and a major addition to an existing high school. The District is about to begin construction on an intermediate school and another four elementary schools in the near future. Without Mello-Roos financing the District simply would not have been able to provide adequate school facilities to house students generated from new residential development. In September 1986, the District's enrollment was 21,184 students; by September 1991, this figure had grown to 26,127 students. Major portions of the District remain to be developed, and through the CFDs formed over this undeveloped property under the Act, the District can be assured of having financing available to build the necessary facilities.

The District strongly supports the current Mello-Roos financing structure and recommends the State Treasurer's office leave this structure alone. Understandably, there have been some concerns over Mello-Roos Bond sales due to recent newspaper articles. The District believes that the key to sound Mello-Roos financing is through careful and cautious formation of CFDs, based on independent appraisals of land values, developing a rate and method of apportionment which provides for adequate debt service payment, and use of a professional team with experience in the field.

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SUPERINTENDENT
Dr. Peter A. Hartman

If Mello-Roos financing was no longer available to school districts, the demand upon the state for funding for school facilities would increase beyond the current back-log of funding requests. At the present time there is a $5 billion back-log of requests for funding for school facilities.

The District appreciates the opportunity to provide this letter of support for Mello-Roos Bond financing under the Act. We would appreciate being kept informed of any "reform" considerations which may be circulated.

Sincerely,

Robert J. Cornelius

Robert J. Cornelius
Assistant Superintendent
Business Services

(CFD.4734/sb)

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January 14, 1992

Steve Juarez
California Debt Advisory Commission
915 Capitol Mall, Room 400
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RE: Mello-Roos: A System That Does Work

Dear Juarez:

It was exactly ten years ago, in 1982, that the California Mello-Roos Community Facilities District Act was passed. Designed as a mechanism to make up for the financial slack resulting from the restraints of Proposition 13, the Act provided a means which would enable development activity to continue to meet the demands for public infrastructure.

Mello-Roos proved popular among developers, builders, and public agencies alike, for the straightforward reason that it provided a workable means to provide financing for public infrastructure.

Even in boom times, escalating costs of infrastructure, soaring developer fees, and the complexities of merging public and private agency goals and interests have made Mello-Roos an invaluable tool. In the current economic environment, in many areas it is the virtual lifeblood of new development.

This crucial importance was not, however, instantaneously apparent. In the early days of its use, the first lesson was that Mello-Roos is not necessarily a simple answer. As public agencies, development groups, and other entities began to more aggressively use the financing options Mello-Roos provided, it was quickly recognized that effective implementation required careful thought and planning.

Critical issues, such as the mechanism for clear disclosure, and the appropriate relationship between developers and public officials, have been resolved as the process has matured.

From the beginning, Mello-Roos provided a tool to accomplish an important task. But it has been necessary to develop special skills to use that tool to greatest advantage.

With hundreds of Mello-Roos Districts now successfully established throughout the state, and bond financing to the tune of three billion dollars, it's clear that those skills are now in place.

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Ironically, as the Mello-Roos system approached the ten-year mark, it came under intense media scrutiny. Publications ranging from the Wall Street Journal and the LA Times, to local papers such as the Modesto Bee, have recently examined Mello-Roos system and pronounced it shaky.

To the uninitiated, such reports were cause for alarm. To those who work with Mello-Roos, they were either rehashed iterations of early problems now better understood and solved, or, in some cases, outright misinterpretations of the Mello-Roos structure. The predictions of doom are driven by the alleged falling real estate values in California and the resultant potential for delinquent tax payments and foreclosures.

To those who question the prudence of invoking Mello-Roos, there is one simple answer: ten years of demonstrable success. For those who wish to delve a little deeper the answers are just as clear. Mello-Roos works... for those who have the know-how to do it right.

In the case of Mello-Roos, *"doing it right"* means careful, reality-based planning. It also means the implementation of safeguards to ensure the process is correctly used.

Mello-Roos financing is secured through the value of the land. Even in a strong real estate market, land values must be realistically appraised, so the value-to-lien ratio reflects a potential land value in a depressed market. With land-secured financing, the bond market generally looks to land being used for the security as having a value of at least three times the amount of the bonds.

Some critics look at the system of bond financing and find it vulnerable. To my knowledge there has been no bond defaults of Mello-Roos bonds in California to date. Certain problem areas have needed special attention so that defaults have not occurred.

The most critical period in the life span of any land owner Mello-Roos CFD is in the earliest stages, at that time when bonds have been sold, and the majority of the land in the CFD is undeveloped and is owned by a limited number of owners. But should a delinquency occur during this phase, there is fiscal protection built into the bond program. Most Mello-Roos districts are structured with a reserve fund that generally will provide up to one year of debt service for the bonds. If property owners do not make their tax payments, the administering agency can make the bond payments from the reserve fund. The agency then has the right to foreclose on any properties who have defaulted on their tax payments. Funds received from the sale of property is used to replenish the reserve fund and pay the bond holders.

Once development begins, and homeowners begin paying their Mello-Roos taxes, even these minimal risks are reduced. Where homeowners are unable to pay the special tax, the public agency could foreclose to secure payment. Realistically, however, it is unlikely that a homeowner or mortgage holder will allow their $150,000 residence (for example) to be foreclosed for non-payment of a $1,500 tax bill.

Another key element in the planning process is timing facility construction to operational need. In its most basic terms, that means that it makes no sense to build a school or any other public infrastructure before the need for that facility is demonstrated.

Timing of the build-out, and sale of bonds, are processes which must be constantly refined. Once the initial bond sale has been made, no further sales should occur until growth is underway, and the subsequent debt is supportable by the developed property.

Where these guidelines are followed, Mello-Roos is proving effective and important for growth, in virtually any economic climate. It does not, in and of itself, stimulate development. It merely provides a practical, realistic, and fair means of funding public impacts associated with the growth.

Why is the system now being questioned?

One reason is a lack of understanding of the process. In some cases normal events, such as a slowdown in growth due to the changing economy, have been laid at the door of Mello-Roos. In other cases, events that are a natural part of the learning curve, such as too-quick construction of facilities, have been inaccurately cited as evidence of a flawed system.

There is no question that there have been problems with some districts, particularly those which were among the first formed. The misdirection of process which resulted in those problems has now been recognized, and corrected in more recently formed districts.

A more insidious problem, has been incorrectly linking Mello-Roos with other legislative tools whose weaknesses do often outweigh their potential usefulness. Marks-Roos financing, for example, provided cities with too-easy access to large bond pools, creating indebtedness woes that far offset potential benefits. Because of extensive problems, Marks-Roos is now under legislative review.

A related system of financing, Metropolitan Districts, used in Colorado, has run into trouble because of inherent flaws which have been well avoided in Mello-Roos legislation.

Steve Juarez
01/14/92
Page 4

Beyond these points of consideration is another factor which merits attention. That is, the current economic turmoil.

In the decade since Mello-Roos was introduced, we have come full circle. 1982 was a year of economic slowdown, and a time when new sources for development momentum were sorely needed. Mello-Roos was designed to offer such an option.

Now, we have again entered a period when we must maximize financial resources. The economy dictates that we be cautious, and avoid excessive risk. But it also dictates that we make the best possible use of our proven tools.

A decade of success has demonstrated amply that Mello-Roos Community Facility Districts fall into that category.

My comments stem from personal experience in structuring and administering Mello-Roos Districts in Northern California. Additionally, I have organized and sponsored several day long seminars for the University of California at Davis providing education and guidance to Public Agencies and private developers on the critical success factors for Mello-Roos Districts.

Very truly yours,

Jerry L. Slinkard, P.E.
Principal

JLS/ckw/wp0004/juarez.ltr

MUNI-GUIDE CORPORATION

January 15, 1992

Comments submitted to the California Debt Advisory commission special hearing on Mello-Roos bonds.

Most of the questions raised in recent articles about Mello-Roos financing have been concerned with why issuers have exposed taxpayers and investors to a variety of undisclosed risks just to finance private development projects. You are now seeking comments on these problems and trying to come up with some workable answers.

We think that carefully drafted legislation can improve the Mello-Roos special tax formula rules as well as certain administrative practices including new requirements for full disclosure to affected taxpayers and property owners. However, the question of Mello-Roos bond quality is more complex. The possibility of State imposed bond quality standards are of great concern to local governments. This type of change could adversely impact their control of planning, environmental, economic and capital facility programs without addressing real world public financing management needs.

It was Standard and Poors Corporation that originally brought these Mello-Roos bond default risks to national attention through a Wall Street Journal article. Regardless of whether their predictions prove accurate, we believe that there has been a key element missing from the financing process that could have helped local public entities to measure and control the quality of Mello-Roos bond issues. In fact, it is possible that if local issuers had the proper tools available to measure Mello-Roos bond risks, we would not even be discussing these problems today.

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The question remains, if local agencies had fully understood the bond risks they have been exposing investors to, would they have gone ahead anyway? In our opinion, they probably would not have gone ahead. In our experience, when local public agencies have a way to objectively measure this bond risk potential, they usually find ways to minimize it and keep it within acceptable public policy limits. Unlike most municipal bonds, the quality of Mello-Roos bonds can be largely controlled by the issuer and its financing team.

Most municipal bonds are subjected to ratings issued by one or more of the three national rating agencies. These ratings generally provide a yard-stick that enables both the investor and the issuer to double-check the quality of the bonds being offered. Ratings also can help public agencies to make sure that the public revenues and resources securing the bonds are within generally accepted financing feasibility guidelines.

There are several reasons why most of the Mello-Roos bonds now outstanding have not been rated. Of particular concern are the "dirt bonds" or bonds that are issued to finance the cost of public facilities for land development projects. One reason development bonds have not enjoyed the benefits of the rating process is because of the complexity of accurately evaluating the underlying real estate security. Contrary to popular opinion, many of these bonds can meet investment quality standards. A number of industry participants recognize that the security aspects of Mello-Roos bonds are not widely understood. (Please see Muni-Guide Rating Criteria attached.)

In a recent article, Dean Misczynski, Principal Consultant with the State Senate Office of Research is quoted as saying that Mello-Roos bonds are usually not rated because the long established rating agencies are only "equipped to tell you this is a developed district and gets an 'A' rating, or they can tell you its undeveloped so it's a BBB - minus. They don't give you in between information for real world Mello-Roos bonds" he continued, "so there is no rating information of any value to anybody." (California Public Finance, Brad Altman, December 9, 1991)

We believe that State legislation and regulatory control will not provide a workable method of dealing with these complex questions of Mello-Roos bond quality. At the same time, it is not realistic to expect that all public finance professionals will voluntarily change their ways and override their monetary interests by imposing on themselves meaningful credit and disclosure standards for Mello-Roos bonds. Mello-Roos bond investors are also not apt to band together and insist on uniform standards for credit analysis and disclosure.

A new comprehensive rating system designed specifically for Mello-Roos bonds might be the key element needed by local government issuers to monitor and control bond quality. A better rating system also might help financial advisors and underwriters to communicate more accurately with issuers when the key credit decisions are being made. Such a rating system is now available. Our conclusion is that this rating system is the most practical way for a local agency to control it's Mello-Roos bonds and make sure they meet minimum quality standards.

PETTIS, TESTER, KRUSE & KRINSKY

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January 15, 1992

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WRITER'S DIRECT DIAL NUMBER

12500-00042
OUR FILE NUMBER

Kathleen Brown
California State Treasurer
Chair, California Debt Advisory Commission
915 Capitol Mall, Room 400
Sacramento, CA 94209-00001

Re: Mello-Roos Financing in California

Dear Ms. Brown:

I am an attorney in private practice who spends a substantial amount of time working with developers and landowners who are concerned with the provision of public facilities and services, including school facilities, in new communities throughout California. My purpose in writing is to provide a perspective on the use of the Mello-Roos Community Facilities Act of 1992 (the "Mello-Roos Act"). The perspective I offer is that of the developers and landowners who are faced with the often conflicting tasks of providing housing and meeting the demands of federal, state and local government and existing residents to provide the public facilities and services required to serve a new development and existing communities. I would also like to offer some concrete suggestions for improving the Mello-Roos Act and some comments on the Commission's proposed Planning and Project Evaluation Guidelines.

BACKGROUND

At the risk of using an often misused phrase, Mello-Roos Districts are not the problem, they are the solution to a problem that has multiple causes. Proposition 13 began a pattern of passing the bill but not the bucks for financing public services and facilities in California. As a result of Proposition 13, the burden of financing the costs of government

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have been disproportionately allocated among otherwise similarly situated residents to the point where the property taxes paid by Ms. Jones on her 3-bedroom home may be five times the property taxes paid by her next door neighbor Ms. Smith. The State has passed and continues to pass the bill for financing essential services and facilities to local governments and school districts. Local governments and school districts have, in turn, attempted to pass the bill to the developers of new housing. The resulting increased housing prices are paid by, guess who, Ms. Smith. The Mello-Roos Act created the mechanism for paying the bill. It did nothing and cannot in any practical sense do anything to correct the pattern of inequities begun by Proposition 13.

Many communities in California have insisted that, in order to maintain a certain "quality of life" for their existing and future residents, the impacts of growth in their community must be remedied prior to the time growth occurs, not after. The Mello-Roos Act has provided a mechanism to achieve this objective.

Now the bank and savings and loan industries have dropped out of the business of providing the credit that has been the lifeblood of economic growth and the provision of housing in California. The Mello-Roos Act has provided a mechanism to fill a portion of the void left by the retreating lending institutions.

WHERE WE ARE TODAY

In the face of the Mello-Roos bashing that has become popular in the press of late, it is important to reiterate the validity and utility of the Mello-Roos financing mechanism. The Mello-Roos Act is sound. In application, the mechanism works smoothly and fairly. Abuses of the law are rare. With the increasing involvement of experienced professionals in the process and exposure of those few abuses that have occurred through the Commission's efforts and the press, abuses should virtually disappear entirely.

The Mello-Roos Act works and it has found acceptance in the homebuying market. The January 3, 1992 Business Section of the Los Angeles Times, Orange County Edition (attached) listed the top-five best-selling detached and attached residential projects in Orange County over the first three quarters of 1991. Of those ten projects, nine are included in Mello-Roos districts.

It may be no small coincidence that the planned communities that have utilized the Mello-Roos mechanism are those that are most successful in these recessionary times.

WHERE WE NEED TO GO

1. Project Evaluation Guidelines.

The CDAC report entitled Mello-Roos Financing in California (the "Mello-Roos Report") does a very good job of pointing out the post-Proposition 13 realities that have led to the increased use of the Mello-Roos financing mechanism by local governments. It would be very difficult to argue with the "Project Evaluation Guidelines" set forth in the report as sound general parameters within which to analyze a proposed Mello-Roos financing. This is no doubt due to staff's decision to seek the input of well-qualified practitioners in the public finance area. With one exception, none of those Guidelines need to be written into the Mello-Roos Act, however. The bond market itself provides an excellent policing mechanism by rejecting proposed Mello-Roos issues that fail to meet many of the general parameters proposed in your Project Evaluation Guidelines. The Mello-Roos Act could be strengthened by providing more focused consideration in the formation process of disclosure of the Mello-Roos district and special tax to the ultimate taxpayer. Perhaps, a discussion of the means and content of disclosure should be a requisite element of the resolution of intention or resolution of formation.

2. Planning Guidelines -- State Responsibility for School Funding.

Under the guise of providing so-called "Planning Guidelines," the Mello-Roos Report actually delivers a Trojan Horse to local governments that will lead them further down the road towards fiscal disaster. With all due respect, the Mello-Roos Report falls apart when it departs from its stated objective of reviewing the Mello-Roos Act and providing guidelines on its use and ventures into furthering the State policy of passing the bill for educating California's children to local government and new development. As stated in the Mello-Roos Report, Mello-Roos Districts may only be a partial solution. The rest of the solution must come from the State. Looking to Mello-Roos Districts to bail out the State will only further tarnish Mello-Roos bonds in the press and bond market. That result is contrary to what I thought was the Commission's goal.

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Any suggested guidelines for addressing school facilities funding through local public financing mechanisms should never stray too far from the topic of how the State will meet its responsibility. As is perhaps the natural tendency of any State agency, the Commission's suggestions and interpretations of the law pay lip service to the State's responsibility and show a distinct bias towards passing the bill without contributing the bucks.

Contrary to the implications of the Mello-Roos Report, recent court decisions in the area of school facilities financing do not require cities and counties to shoulder the full responsibility for insuring adequate educational facilities. Moreover, the suggestion that school capacity issues should be addressed in a community's State-mandated general plan is a thinly veiled attempt by the State to now further escape from its funding obligations through the State's planning and zoning laws. The Report suggests that level of service standards should be specified in the general plan for school facilities and the standards should be the State-mandated costs and area standards schools promulgated by the State Allocation Board. In pertinent part, the Mello-Roos Report states that "[p]lacing the standards in the general plan demonstrates the commitment to mitigating the service impacts of growth according to specified criteria." Any practicing land use lawyer, city attorney, county counsel or school district lawyer knows that what this commitment means is that all new development will be required to guarantee 100% financing of new school facilities in order to demonstrate the "commitment" to meet the State-imposed legal requirements of general plan consistency. My recommendation to any local government would be to not include within its general plan the kind of specific school financing policy suggested by the Mello-Roos Report until the State guarantees its participation in providing funding. To do otherwise is to let the State off the hook and place the local government squarely on it.

The Mello-Roos Report suggests changes in existing law to permit simple majority, rather than two-thirds voter approval of local general obligation bond issues and community facilities districts for schools to allow for a more equitable distribution of the school facilities funding obligation across the community. While this is preferable to the solution of requiring new development to pay 100% of the costs, it is not the entire solution by any means. First, any change in the law that reduces the voting requirement for school general obligation bonds must be accompanied by a change in the law that would exempt or otherwise give appropriate credit to those areas of a community that are contributing school funding through an existing community facility district or some other means. Failure to do so will not only further the inequities created by the particular general obligation bond issue vis-a-vis Prop. 13-benefitted landowners, but may also throw an unsurmountable political obstacle in the way of the proposed bond election. Second, making it easier for a local community to finance school facilities should not be viewed as a way of bailing the State out of its obligations. Again, any change in the law permitting simple majority-approved general obligation bond issues, or community-wide community facilities districts for schools should be accompanied by legislation guaranteeing to local government that the State will shoulder its share of the obligation to educate California's children.

Thank you for considering these comments and suggestions. The Commission's efforts are greatly appreciated and will hopefully result in a clearer understanding of California's infrastructure financing problem and the means of solving it.

Very truly yours,

John P. Yeager

JPY/lcc

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767 Fifth Avenue, New York, New York 10153 212/486-5800 Cable BEEPERIOD

January 20, 1992

Honorable Kathleen Brown
Treasurer
State of California
915 Capitol Mall
Room 110
Sacramento, CA 95814

Dear Ms. Brown:

After attending the meeting you chaired on Mello-Roos financing on January 15th in Orange County, I wanted to take the opportunity to add my own comments. As Director of Municipal Credit Research, my perspective is that of the bond buyer/investor.

Obviously, one of our primary aims is to insure the safety of the investment we make on behalf of our clients. However, one of the issues that was not adequately emphasized at the meeting was our concern over bond liquidity. We, and many larger institutional buyers, rarely hold our bonds to maturity. Concerns about safety, as is currently the case for Mello-Roos bonds, translate into less liquidity, i.e. greater difficulty in selling bonds at reasonable prices. A more informed market would go a long way to resolving this problem.

In fact, one of the most important points to come out at the meeting was the lack of adequate secondary market disclosure. I cannot emphasis strongly enough how important an issue this is as we rely on our own research in making any investment decision. There is clearly the need for continuous and timely information on an ongoing basis, not just at the time of bond sale. It's interesting that most municipalities wouldn't think twice about providing disclosure for their general obligation, lease revenue/certificate of participation, or enterprise revenue bonds. Yet many assume no responsibility for disclosure about their Mello-Roos (or assessment bonds).

As a buyer of California bonds, we have hundreds of issuers and thousands of securities to choose from. Faced with the prospect of lack of information, especially when the security is inherently more risky to begin with (as we feel Mello-Roos bonds are), just leads us to avoid them in the first place.

That is why I found the suggestions to mandate minimum levels of disclosure as worth pursuing. I know how difficult that whole process may be. In considering that approach, I urge you to pay special attention to the issues of:

1) who would be a central repository of such information;
2) what information is to be collected;
3) how often information is to be collected;
4) who would be required to submit information;
5) how such information is to be stored; and,
6) how information will be disseminated (insuring timely distribution and equitable access to such information).

Information that I would like to see includes:

I. Status of development:
   1. number and value of residential acres developed;
   2. number and value of homes built;
   3. number of homes sold;
   4. default rates (CFD tax and any other tax);
   5. number and value of commercial/industrial acres developed;
   6. space developed;
   7. vacancy rate;
   8. default rates; and,
   9. any lawsuits by homeowners or others.

II. Status of capital projects:
   1. information on project and budget status;
   2. fund balances in various accounts; and
   3. planned additional borrowing.

III. Other
   1. Overlapping debt statement;
   2. Total tax rates;
   3. Management comments on original appraisal and absorption reports; and,
   4. Current list of information contacts.

I would also like to make a comment about some discussions regarding bond insurance or the State of California insuring Mello-Roos bonds. I doubt that any insurer will be willing to broadly provide bond insurance for Mello-Roos bonds. Their own AAA ratings are dependent on maintaining certain underwriting standards and insuring non-rated Mello Roos bonds could jeopardize their own ratings.

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In the event the State would be willing to insure the bonds (as it does for certain health facility bonds), be aware that insured debt could be considered as State obligations. Analytically, that could then add to the State's own debt position, something the State can ill afford, particularly at this time.

I found the public hearing to be a positive first step by the State in addressing developing concerns regarding Mello-Roos financing. I also noted your enthusiasm for seeing constitutional changes to allow a majority vote for general obligation bond authorization. Such a change would do much to help California's municipalities meet their capital financing needs (and probably at lower borrowing costs).

Please do not hesitate to call me if you have any questions regarding my comments or would like some clarification.

Sincerely yours,

Joe Rosenblum

Joseph Rosenblum
Director - Municipal
Credit Research

cc. Steven Juarez
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MODESTO CITY SCHOOLS

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January 21, 1992

Steve Shea
California Debt Advisory Commission
P.O. Box 942809
Sacramento, CA 94209-0001

Dear Mr. Shea:

I was disappointed to not be able to attend the Mello-Roos hearing in Santa Ana. Unfortunately, the District's travel budget is severely restricted and I was not able to be there, so I am sending these comments to be included in whatever analysis the Debt Advisory Commission and its staff will be making.

As you know, Modesto City Schools has been active in pursuing a variety of means to finance our expanding facility needs. We have utilized developer fees, Certificates of Participation, General Obligation Bonds, and Mello-Roos to finance a construction program of approximately $100,000,000 to date and growing. We have housed an additional 8,655 students in six years <u>without</u> State funds. Mello-Roos will be our primary tool to meet continuing facility needs caused by new residential development. With the declining ability of the State to help local agencies with infrastructure needs, I firmly believe that more school districts will need to develop similar comprehensive and diverse funding programs to accommodate the growing school-age population in California.

Based on my experiences as both a school planner and Mello-Roos administrator, I would like to call attention to some specific situations and to respond to some common criticisms.

OUR FOURTH R IS RESPONSIBILITY

Is Mello-Roos fair?

Many complaints are heard that the new-home buyer should not bear the total cost of providing new infrastructure in a growing community, especially as relates to schools. The new-home buyer certainly should not be expected to pay for increased or improved school facilities necessitated by demographic trends (the "baby boomlet") or deteriorating facilities rather than by new development. However, a properly designed Mello-Roos Community Facilities District will allocate through the special tax the cost to provide school facilities to serve only that new home, without which those expenditures would not be needed.

Shouldn't the entire community pay for schools?

Yes, up to a point. Our case in Modesto is an excellent example in which the entire community voted overwhelmingly (72%) to approve general obligation bonds and tax itself to provide adequate schools to serve the existing population. But what comes after a general obligation bond? New development in Modesto is creating a need for school facilities beyond what we could have provided with the general obligation bond mechanism. Current voters are unlikely to feel it's fair to pay for additional schools to serve new homes. The Mello-Roos mechanism providing that existing general obligation bond rates be frozen at undeveloped property values when a Mello-Roos is added allows the new-home buyer to fully pay for his impact without paying for pre-existing facilities as well.

Who gets to attend Mello-Roos schools?

Some Mello-Roos taxpayers in Tracy have raised a concern that their children are not all attending the new Mello-Roos schools and that other non-Mello-Roos taxpayers' children are. This argument at first appears compelling unless one understands the basic underlying premise of Mello-Roos districts and the educational realities of providing school facilities.

The best way to explain this is that a Mello-Roos house is buying capacity in the system, not a desk in a particular school. This is especially obvious in a situation in which a new school will not be built with the special tax funds, but existing schools simply expanded to meet the increased demand. It also applies to situations such as Tracy where the revenues from the special tax are insufficient to fund the building of a school in the early stages of development.

When development starts in a Mello-Roos district, students will require schools but the special taxes from the initial development will be too small to finance the construction of a new school. The initial Mello-Roos residents must attend an existing school facility. This situation will continue until enough funds are generated to build, open, and operate the new school.

At this point, the dynamics of phasing in attendance area adjustments with the least disruption to all students - including those from the Mello-Roos areas - takes over. As a veteran of fifteen years experience in making school attendance boundary adjustments I can say that it is one of the most difficult tasks facing any school district. We try to cause as little disruption and reassign as few students as possible but changes must be made and often phased in over a period of time. Opening a new school and the resulting reassignment of students throughout the district is a difficult task for all concerned. As the situation in Tracy evolves, more "Mello-Roos" children will probably attend "Mello-Roos" schools. During the phase-in period, a school district simply does its best to get all students seats in a classroom with as little negative impact on the individual student's educational program as possible.

Non-contiguous CFDs are another example to support the premise that the special tax contributes to the overall system rather than a specific school. For example, if six developments in several different parts of a district all become part of a CFD and one new school is built with those funds, it obviously can only be built in one place and cannot directly serve the children from all the developments. However, by restructuring existing school attendance areas to redistribute enrollment, Mello-Roos children will find that there is now room at their neighborhood school because of the relief "their" Mello-Roos school provided across town.

I realize this has been a very convoluted and detailed attempt to explain why a situation which may appear to a resident or taxpayer as unfair is in reality quite justifiable. The key is to emphasize that Mello-Roos contributes **system capacity** rather than buying a specific facility.

Developed versus undeveloped land tax rates

Some argue that a developer should bear the same tax burden as the eventual home buyer and should pay the same amount per acre as the homes eventually built on that acre will pay. In the best of all worlds this would be wonderful and would allow a CFD to bond for more money earlier and get facilities in place faster. Unfortunately, economic realities dictate against this plan.

If this requirement were in place, Mello-Roos districts that are currently secure because of the lower level of debt in the early years when ownership is concentrated in the hands of one or a few owners would be in dire financial straits if the tax burden were too high and developers defaulted. A balance must be struck which allows infrastructure development to begin early at a tax level the developer can realistically pay. If the tax burden in the early years is too large, a developer could not afford to put in all the infrastructure to support an entire, multi-phase development. In addition, the actual impact on facility needs does not occur until the homes are in place.

Fees versus special tax

There is one final reason I would like to point out why Mello-Roos is an excellent and important tool for funding school facilities. The courts have ruled that new development approvals can legitimately be conditioned upon mitigation of school impacts. Absent a money tree being discovered by the State Allocation Board, this mitigation will most likely be from either a Mello-Roos special tax or a developer fee. One way or another new growth must pay its way and the eventual cost will devolve to the house buyer. So the question becomes which is better, a fee or a special tax?

A fee is not paid by the developer, despite the term "developer fee" and what builders would have us believe. The fee is added to the cost of the new home and is assumed by the buyer as part of the cost of the home - and as part of the mortgage. Financing the cost of that infrastructure at tax exempt rates, instead of mortgage interest rates, will reduce the overall costs. And, if the home buyer is well-informed and mortgage company appraisers are doing their job, the purchase price of the Mello-Roos house will be lower. Additionally, the special tax is deductible on income taxes whereas the portion of the purchase price attributable to fees, other than the interest paid, is not.

All in all, a well-informed home buyer would opt for a Mello-Roos home rather than a "fee" home, if all houses for sale in an area were carrying their fair-share burden of infrastructure costs. As is always the case during times of transition, we unfortunately have a mixed bag right now so that clean comparisons may not be easy for the average home buyer.

Summary

Having worked with both development of a comprehensive long-range school funding plan and the administration of a Mello-Roos CFD, I believe Mello-Roos must remain an integral part of California's infrastructure financing system. This is not to say improvements are not needed. Disclosure requirements still need to be strengthened and the public agency should have more control over how that disclosure is made. A governing board should be able to dictate to the home seller how disclosure will be made. Right now, the public agency can only hope it won't be left later on trying to explain to taxpayers something that should have been disclosed by a seller who has long since left town.

An option for a "buy out" may be a reasonable requirement in order to make it clear to a home buyer that infrastructure costs are an integral part of the home - whether as a tax or in the purchase price.

As always, I would be glad to answer any questions, explain this dissertation in more (or less?) detail or help in any way I can with the Commission's analysis of Mello-Roos financing. It is a strong tool in California's arsenal and must be maintained if we are to keep afloat.

Sincerely,

MODESTO CITY SCHOOLS

Deborah S. Bailey

Deborah S. Bailey, Director
Planning and Research

DSB/lr

WRITTEN TESTIMONY BEFORE THE
CALIFORNIA DEBT ADVISORY COMMISSION
HEARING ON THE MELLO-ROOS ACT OF 1982

January 15, 1992

Prepared by

MARIE L. MARTINEAU
O'MELVENY & MYERS

I appreciate the opportunity to participate in these hearings as legal counsel in Mello-Roos financings. My firm has been active in the Mello-Roos area for some time. I began participating, mainly as underwriters' counsel, in Mello-Roos financings in 1988. In that time, I have seen a growing awareness of the usefulness of such financings for regional and local infrastructure needs. I have also found that most local governments take their responsibilities to taxpayers and investors very seriously.

My perception is that Mello-Roos financing has become a necessary tool in getting infrastructure built in developing areas. The types of facilities and services which can be financed by Mello-Roos districts are well-suited to areas of new development. Mello-Roos financing, used responsibly, can equitably spread the burden of paying for local and regional improvements made necessary by new development.

Legal counsel often does not get involved until the point at which the sponsoring entity is ready to proceed with actual formation and financing of a district. As either bond counsel or underwriters' counsel, my firm's objectives at that point are to see that the district is properly formed, that the special tax formula works within the bounds of the law, that the bonds are legal and tax-exempt (if meant to be) and that proper disclosure is made to potential investors. As one of my underwriter clients describes it, our job is to see that truth and light prevail. Put this way, our goal in acting as counsel in a Mello-Roos financing is no different from any other kind of financing. The nature of Mello-Roos financing is such, however, that reaching that goal can get complicated.

The job of counsel is made a great deal easier if, long before a financing begins, the governmental entity has adopted guidelines detailing the circumstances under which they will form and finance a Mello-Roos district. To be most useful, such guidelines set the policy of the sponsoring entity and address security issues such as appraisal standards, describe what is expected from the developers, detail the types of infrastructure which will be financed and similar matters.

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I am fortunate in that every issuer with whom I regularly work has adopted such guidelines with significant input from their experts. Increasingly, the lawyers and other consultants are involved in the formulation or revision of guidelines, a process which makes everyone's life easier in the long run. Policy decisions are for the issuer to make but input from those with experience in the area is invaluable.

The State has an opportunity to provide guidance in this area. The Mello-Roos report issued by the Commission last fall was helpful in this respect. I would be reluctant to see the State actually set guidelines for local entities because many of the issues which need to be addressed are dependant on local conditions. However, the State's encouragement of the need for responsible guidelines should continue. The State and the Commission also have a role to play in the education of local governments, especially those new to Mello-Roos financing. Sample guidelines or lists of issues which should be considered in promulgating guidelines would be very useful. Such guidance would assist new and seasoned issuers by giving them the benefit of others' often painful experiences.

One area that does need to be addressed is disclosure - both to taxpayers and to investors. My firm is concerned about the possible vulnerability of the landowner vote used in most cases to form districts and approve special tax methodologies. We typically require a validation suit prior to the issuance of bonds and opining thereon. It is my understanding that most, if not all, bond counsel in the State have the same requirement. Despite a successful validation action, concerns do exist regarding challenges to the landowner vote.

The issuers with whom I work all require that notice be given to homebuyers in a form approved by the issuer. However, many of the notices which I have seen are not as clear as they could be. Standardization in this area may be helpful. Taxpayers who understand what they are getting into are less likely to feel mistreated by the process.

Recent negative publicity about Mello-Roos financings underscores the need for full disclosure to investors as well as to taxpayers. Issuers frequently think that disclosure to investors and drafting the disclosure document are the underwriters' problem. Rule 15c2-12 and the Supply System litigation which prompted it have made it clear that the disclosure document is the issuer's document as well as the underwriters' and that a great deal of attention needs to be paid to disclosure of the risks of a financing.

This point has not been lost on most issuers but small or infrequent issuers may need some guidance in this area. I do not think it is possible to standardize disclosure although some

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may disagree. However, the need for standards of disclosure is there. For example, disclosure regarding the financial status of large landowners in an undeveloped district is often inadequate. Developers are frequently reluctant to divulge their financials or details about their financial arrangements. Until a year or so ago, not too much attention was paid to the details of a developer's financials or who its lenders were. In this era of developer bankruptcies and failed lending institutions, such details are increasingly important. Issuers need to understand the importance of such disclosure and to insist that landowners divulge such information and allow it to be disclosed in an official statement. It would be helpful if such matters were addressed in the issuer's guidelines and made clear to the participating landowners at the start of the process.

Disclosure regarding the financial health of large landowners and their lenders is just one example. Similarly, disclosure about the relative strength or weakness of the local economy, the appraisal used to evaluate the district and the assumptions that went into it, the lien-to-value ratios of the district and in some cases of discrete parts of a district, environmental, regulatory and other factors which might slow down or stop development all need to be disclosed. All of these matters should be addressed by the issuer at an early stage.

The State should be wary of mandating specifics as disclosure is so dependent on individual circumstances. However, the State can assist educating issuers about their responsibilities regarding disclosure and in assisting in the creation of standards of disclosure.

In conclusion, additional local action may be needed in many cases to improve the protection afforded to taxpayers and investors by the Mello-Roos Act and current practice. State action may be desirable but care should be taken in any legislative response. In my view, the areas to be addressed do not lend themselves to a statewide legislative response because they are dependent on local circumstances. The State does have a role to play - by providing guidance to local governments and by developing statewide standards for the protection of taxpayers and investors.

Hearings such as this one are a good start. In my experience most frequent users of Mello-Roos financing have given thoughtful attention to this area. Much can be learned from their experience and the input of underwriters, experts and taxpayers. Mello-Roos has been and will continue to be an important tool for local governments to address infrastructure needs. It is important for all of us who work in this area to use our best efforts to prevent it from being used irresponsibly.

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TESTIMONY FOR CDAC HEARING ON MELLO-ROOS
January 15, 1992

A. Overview

My name is John Gibson, Partner at Stone & Youngberg. My work as an investment banker for the past seven years has concentrated in structuring a variety of land secured financings in Southern California. Prior to that time I had twenty years experience as a local government financial manager with responsibility for long term financing programs.

We appreciate the opportunity to provide comments on Mello-Roos financing.

The recent down turn in the economy has emphasized certain aspects of land secured financing that deserve close scrutiny. Overall we feel that Mello-Roos financing is an extremely valuable tool that should be sustained but that could be improved with the development of comprehensive local government policies and certain amendments to the enabling legislation.

We wish to complement CDAC for its efforts to date and the Mello-Roos Financing report in particular. The CDAC report starts an education process which we feel is important for all participants, i.e., the Issuer community, developers, bond buyers and taxpayers.

As this tool has evolved and has become more intricate, the market has responded with higher buyer awareness and sophistication. In fact, invester discrimination is helping promote tighter underwriting criteria, issuer involvement and ultimately better security.

1. **What are your firm's objectives when structuring a Mello-Roos financing?**

   Our first objective is to help identify the issues that affect the structure and security for the financing and make sure they are discussed with the local officials, and that the consequences of choosing one course of action over another is property understood by the issuer.

   In this regard we attempt to balance the needs of all participants, i.e. issuer, developer, taxpayer and bond buyer with a long-term perspective. Since the issuer has ongoing responsibility for the financing, we attempt to assist the issuer look ahead in the life of the project, to anticipate potential problems and address them during the formation process.

2. **Do you feel that the interests of the ultimate taxpayers are protected during the Mello-Roos negotiations between developers and local governments?**

   We feel that the interests of the ultimate taxpayer are best served in those situations where the special tax formula is designed to respond to specific policy goals that have been adopted by the issuer.

3. **How vital is Mello-Roos financing in ensuring adequate public service levels in developing areas? What would be the consequences of making it easier for taxpayers to deauthorize unissued Mello-Roos bonds?**

In the absence of alternative financing sources, both public and private, it is our observation that Mello-Roos and other available public financing vehicles are more important than ever before to provide access to the capital markets for the timely installation of required facilities.

Inasmuch as the law currently provides a mechanism to reduce authorized but unsold debt and the maximum tax, we do not feel that any change is necessary. In fact, we are concerned that the Act may provide too much flexibility by not requiring that any proposed reduction be approved only after a finding by the governing body that such action will not result in an impairment of the security for the outstanding bonds.

My name is Scott Sollers, Partner at Stone & Youngberg. I have overall responsibility for investment banking activities at the firm. I've been involved in public finance for 16 years. I believe that Mello-Roos financing is a remarkable tool that can help local agencies finance their capital programs, but certain disciplines are justified.

4. **Do you feel that additional state legislation is needed to strengthen the Mello-Roos Act in any way? Or do you feel that a local response is more appropriate?**

We believe certain aspects of the Act could be revised to strengthen and clarify this financing tool.

Firstly, it may be appropriate to require that any issuer of Mello Roos debt have a substantial interest in the public facilities being financed. Certain imbalances can occur if the issuer is only acting as a conduit for the financing.

Once the issuer is identified, the single most important requirement that would help inject discipline in these financings would be the development of a public policy prior to the issuance of bonds. This policy at a minimum, should address the guidelines set forth in the CDAC report. In developing this policy we feel it is appropriate to form an inter disciplanary committee of appropriate local government staff. This committee should represent all affected areas of local government including public works, tax collection, legal and administrative functions. The objective of the committee is to present information to the elected officials that encompasses the basic structure of the financing, the cash flow requirements and homebuyer disclosure, among other things. We believe that these policy guidelines should be formalized by the elected officials and subject to periodic review.

We feel that certain items such as coverage requirements, use of capitalized interest, tax differentials between developed and undeveloped land, use of the reserve fund and foreclosure covenants should be addressed at the local level. In this regard, we feel that any discussion of value to lien ratios should clearly articulate appraisal methodology in computing value and encompass all land secured liens on a parity with the Special Tax in totaling debt.

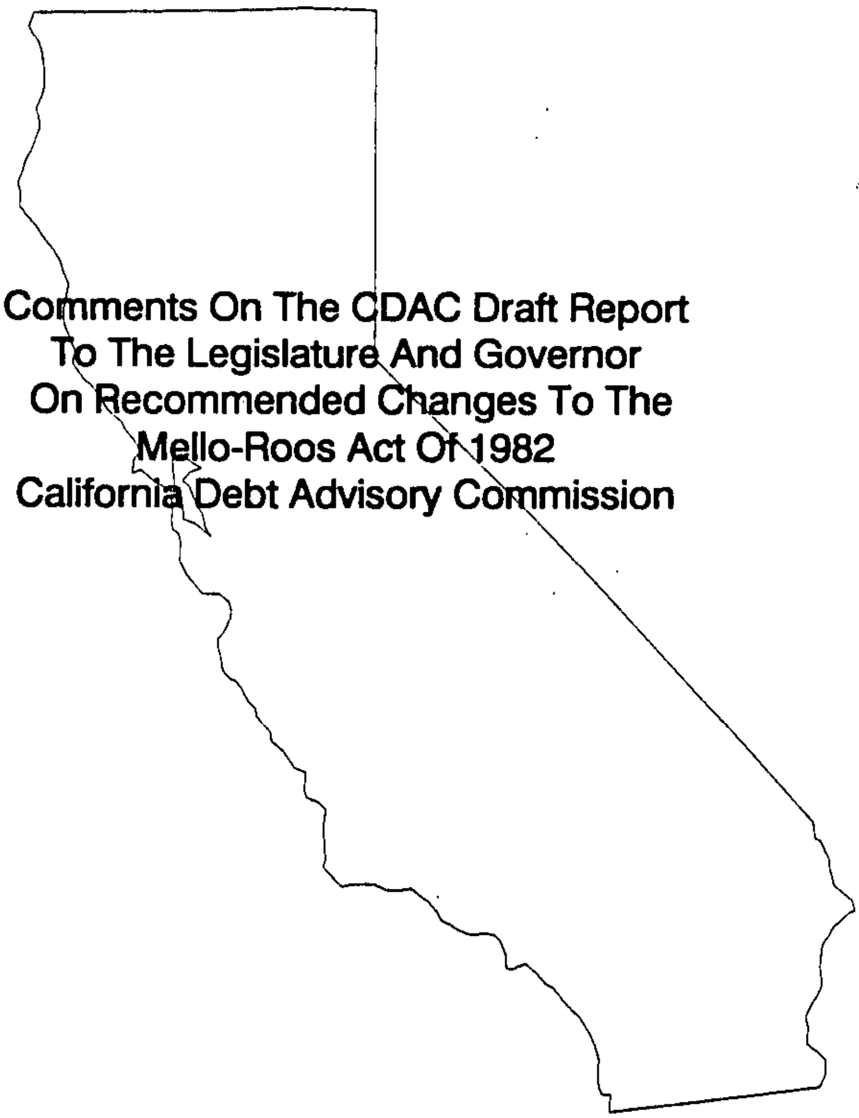
To ensure an appropriate level of objectivity, we feel that the Act should require that any appraisal or absorption study conducted in connection with a bond sale be undertaken independently of the property owner by either the issuer's staff or consultants retained by the issuer even if professional fees are paid by the property owner.

In addition, we believe that certain aspects of the special tax, particularly formulas that require inflators or escalators could be limited though legislation. We also believe that the law should be expanded to require more complete and simpler disclosure to the ultimate taxpayer, particularly within the secondary or resale market.

In summary, we believe that this financing tool is very valuable, that the vast majority of financings have been responsibly structured, but would welcome the opportunity to work with CDAC and the legislature to strengthen the Act.

(WPP/1635)

Section III



Comments On The CDAC Draft Report
To The Legislature And Governor
On Recommended Changes To The
Mello-Roos Act Of 1982
California Debt Advisory Commission

Sacramento, California

SECTION III

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March 5, 1992

California Debt Advisory Commission
915 Capitol Mall, Room 400
P.O. Box 942809
Sacramento, California 94209-0001

Attn: Steve Juarez, Executive Director

Dear Mr. Juarez:

I appreciated the opportunity to speak with you earlier this week regarding CDAC's proposed changes to the Mello-Roos Community Facilities Act of 1982.

The City and County of San Francisco is currently considering the use of the Act in conjunction with the City's Mission Bay Project. The Mission Bay Project is the culmination of over ten years of planning, citizen input, and negotiations between the City and the Catellus Development Corporation. The 300-acre mixed use project offers one of the last opportunities for major new development in the San Francisco, and will include 8000 dwelling units and 4.8 million square feet of office space. While we are still in the relatively early stages of the financial planning for the many public improvements contemplated in this project, it is likely we will use the Act to finance a variety of these improvements involving several series of bonds.

For that reason, I am pleased that CDAC and others have been responsive to concerns expressed with respect to various provisions of the Act and have offered revisions which will make the Act a quality financing vehicle which will accomplish the purposes for which it was designed.

I do, however, have concerns with respect to certain revisions, and respectfully submit the following comments:

Recommendation No, 2: Any annual reporting requirements imposed on a legislative body which has issued bonds under the Act should be based on the reporting of the types of information which the legislative body has reasonable assurance is accurate (i.e. information reported by its fiscal agents, its public works department, and the County tax collector). The legislative body may not have easy access once a project is completed to certain items referenced under "Development Status" such as vacancy rates for commercial and industrial property. Even if this information could be obtained from outside sources such as developers and building owner s, a legislative body may not have a way of verifying the accuracy of this information. While the CDAC report states that the local agency would not be liable for reporting inaccuracies, it is unclear whether this assertion would stand up to the test of federal securities law. To the extent secondary market participants relied on these annual reports to make investment decisions. it would seem that a legislative body's obligation to disclose should be limited to those items which it can determine to be accurate.

While reasonable on-going disclosure will help improve the marketability of Mello-Roos bonds, it should be noted that local governments will be faced with additional costs in providing this information, which will then have to be passed on to taxpayers within the CFD.

Recommendation No. 3: It would seem that the limitation on the annual increase in the special tax of 2% is of primary importance to residential purchasers as distinguished from purchasers of undeveloped properties or property zoned for non-residential use. The recommendation appears to make no distinction between these classification of purchasers.

Again, thank you for this opportunity to comment on this well-conceived and thoughtful report. I look forward to working with you in the future.

Sincerely,

Laura Wagner-Lockwood

Laura Wagner-Lockwood
Deputy Fiscal Officer

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March 6, 1992

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CALIFORNIA DEBT
ADVISORY COMMISSION

Steve Juarez
Executive Director
California Debt Advisory Commission
915 Capitol Mall, Room 400
Sacramento, CA 95814

Re: CDAC Report on Proposed Legislative Changes to the Mello-Roos Act

Dear Steve:

Thank you for your telephone call the other day. The following are my comments on the above-referenced CDAC report.

On the whole I thought the report was excellent, and I agree with most of its findings and recommendations. It is unfortunately in the nature of things that I am not going to spend time discussing the parts of the report that are good, but will necessarily have to direct my attention to the portions with which I differ.

The first issue I wish to raise, and I will raise it on its own because it seems to cross the boundaries of several of your recommendations and findings, is the whole issue of the so-called "hidden subsidies" for the developers. There are those who would argue that the mere presence of public financing itself is a developer subsidy, and under some circumstances they may be right. I do not believe the presence or absence of a developer subsidy is the issue. The issue is how does the subsidy impact the howmeowner, and is that impact reasonable.

Certainly, homeowners can argue that had the issuer not permitted two years of funded interest, the bond issue would have been smaller and the special tax would have been lower. But is that really true? It may be that without the two years of capitalized interest, the bonds would never have been issued, the project would never have been built and the owners would not have had a house to buy. Or if the project had gone forward with a lower tax, the homeowners, as a direct result, might have had to pay more for the house. If the homeowners know the level of special tax burden at the time they make the decision to buy, and get their "Mello-Roos discount" based thereon, then they have not been treated unfairly, and the focus should be on the other issues involved in the subsidy - such as credit quality or development policy.

We should direct our attention to the proper use of the public finance money. There may be good public policy reasons for not permitting two years of capitalized interest. Very well, do not permit it. But the issue is the public policy of efficient use of public funds, not on any so-called "unfair" burden on the taxpayer - because the burden is manifestly not unfair.

Again, I agree with the principle that the developed property should not subsidize the developers, but it is essential to understand that this is a very different and very distinct issue from the question of whether the developed and undeveloped property should be taxed at the same rate. If the developed property has more infrastructure provided to it than the undeveloped property, it is far more reasonable to require it to pay more than the undeveloped property. I have outlined some of the difficulties involved, in such a situation, in taxing developed and undeveloped property the same, and the dislocations and political problems that will result therefrom, in my letter to the Commission prior to the January hearing. I read nuances of response to those arguments in your current report, but your response must be said to be grudging. Someone (maybe my friend Harry Clark) sold you on the idea that charging uniform rates solves the problem. In a few instances, that might be the solution; but as a general rule that solution is wrong, and was offered by someone who only felt one part of the elephant.

The argument that the various areas should then be segregated into separate improvement areas I find disingenuous. A rose by any other name would smell as sweet. Improvement areas add procedural complexity and expense without any difference in substance or perception, from the perspective of a homeowner. To merely call it something else, and then say the very same fact situation is thus made acceptable, is precisely the kind of thing that gets local government excoriated.

We need to face up to the fact that the developed area should pay its fair share. If it pays more than its fair share, then it is subsidizing the developers, and in that case I agree with you that normally should not be permitted unless there are overriding considerations (such as the survivability or existence of the development itself) which are explicitly addressed and considered by the local legislative body. If the developed property is merely paying its fair share, it has no cause to complain that the undeveloped property is paying less. If it agrees to pay more than its fair share for a time, and knows it is doing so in order that the development take place at all, it should be free to accept that burden.

In light of the above, it should come as no surprise that I would disapprove of paragraph 4 in the proposed notice within your recommendation No. 1.

In your recommendation No. 2 I applaud the motive and share your concern about the cost.

As an aside, there are occasional references in your report to the "Governing Board of the CFD." My understanding has always been (and I believe this understanding is shared by Dean Misczynski) that CFD's do not have governing boards. The local legislative body, whatever it may be, acts for the CFD, but it always acts as the legislative body of the local agency, not as the governing board of the CFD. I do understand that there are some bond counsel in southern California who take a contrary view.

On your recommendation No. 3 I have always made the same recommendation. I have been involved in a few districts where we have exceeded the 2% (once with a 3.5% rate and once where we stepped up the tax at pre-specified intervals for a few years and then transferred it to a 2% rate). There is always something lost when flexibility is taken away, and that is regrettable. I would not be inclined to touch this area unless there really have been abuses that you feel need correcting.

In your recommendation No. 4 I urge caution. I heartily approve of the general motive behind the recommendation. Presumably it would not apply to joint powers agencies which are formed by the participating local entities and invested with the power to conduct Mello-Roos proceedings. I have three of such districts. In two of them all of the benefitting local entities are parties to the joint power agreement and have representatives sitting on the joint powers agency board. In one of my districts, four local entities make up the joint powers agency, each has representation on the joint powers agency board, but the agency itself has a joint financing agreement with the local county (which declined to participate directly in the JPA) in order to fund some of the county infrastructure. I believe that the total amount of infrastructure being financed for the joint powers agency members is greater than that being financed for the county, but even if this were not so, I do not see the possibility of abuse in such a situation.

I would also assume that you would like to permit a situation, for example, where a county conducted proceedings, even though it only received 40% of the financing proceeds, where it was conducting the Mello-Roos proceedings for itself and, say, two school districts, each of which, pursuant to a joint financing agreement, were to receive 30% of the financing proceeds. I believe we should encourage joint financing agreements, where one entity conducts the proceedings for all, rather than forcing in every case multiple agencies to combine in a joint powers agency, which is administratively cumbersome and expensive.

Last year's amendment, which required joint financing agreements to be entered into before the CFD could be formed, seems to me a better answer to the concern.

I also believe it is absolutely essential to apply any such requirement only to districts formed after the effective date of the authorizing legislation rather than to bonds issued after the date of the authorizing legislation. Otherwise, you would be in danger of wiping out essential mitigation measures which were put into place to fulfill conditions of development. If the authority of the public agencies to implement that mitigation were now to be wiped out by your legislation, you could create havoc, for it may be impossible with registered voters now present - to obtain a 2/3 vote for a replacement measure.

I am made uncomfortable by your recommendation No. 5. It strikes me as the type of action that can result in unexpected and unwanted impacts for years to come.

When I am assisting in the formation of a district where we authorize a shopping list of possible facilities with no expectation that we will ever finance all of them via the Mello-Roos, I always include a disclaimer to that effect in the documents and in the Notice of Special Tax Lien. I have almost never included cost estimates in any of the official resolutions. Cost estimates are included in the public report prepared for the public hearing but they have never been more than that, estimates, and have never been binding upon the local entities. The mind boggles at all the sorts of engineering games that would start to be played if this recommendation were to be adopted. I admit I have not had the benefit of reading the testimony of John Beckley or Donald Swift to see precisely what abuses they complain of.

Again, making such a requirement applicable to existing CFDs is equivalent to changing the rules after the game has started. In this world of Mello-Roos, where you really get one chance to set up your authority at the beginning, and then must live with it ever after, to undercut that authority after the one chance has passed could be devastating.

On your recommendation No. 6, enclosed is a revised copy of the article sent to you before, which is the best I can currently do in addressing this question. To let the financing "tail" wag the school administration "dog" is clearly wrong.

I do want to take issue with some of the statements in your report, however, as they apply to Tracy. I believe there may have been some misunderstanding on your part, although that understanding may be clarified by the Joint Powers Agency's response to the letter from Kathleen Brown. Briefly, it is and always was the policy of the Tracy Public Schools to send all students to their neighborhood school. I have been given to understand that there were situations in which the children of Mello-Roos special taxpayers, attempting to register at their neighborhood school (which was, in fact, a school paid for by the Mello-Roos financing) were not able to do so because it had become full. This, of course, is something that could happen anywhere in the school district, Mello-Roos area or not. Those students were assigned to the next nearest available school; and it is my understanding that the next school year they are given the option of either staying at the more distant school or of transferring to their neighborhood school. It may be, in hindsight, that the school district should have left more vacant room in the Mello-Roos schools at the beginning of a school year than it left in other schools to accommodate greater than average anticipated growth in that area (they may well have done this, I do not know), but the school district policy cannot be said to be "controversial", or any different from any other school district.

The policy which was requested of the school district, and which it refused to adopt, was a policy which would, in the middle of an academic year, reach into a Mello-Roos school and eject an established student (assigned to that school under the normal school attendence boundaries) from that school, and require of that student a mid-year transfer to a non-neighborhood school, solely because that child's parents were not paying the Mello-Roos tax. That would be extremely disruptive educationally, would create a "second-class citizen" status, and would be contrary to normal practice. The contrary practice of requiring a new student to register in the next available school when the closest school is already full, whether Mello-Roos is involved or not, is the established educational practice, applicable statewide, and does not discriminate against anyone.

You must understand that no policy was ever established to attempt to require Mello-Roos students to attend more remote schools.

What is really irritating about this accusation by the Tracy Coalition, which you folks appear to have accepted whole, is that in addition to being false, three of the people making the accusation (Bob Beaulieu, Julie Gordon and Laurie Axford,) do not even have kids in the system. They either do not have kids or they have put their kids in private schools. John Kraschinsky does have kids in the system but they go to their neighborhood, Mello-Roos school. The former head of the Coalition, Farid Ghalili, who has kids in the system, has asserted in a letter to the newspapers that this problem has been resolved. Because of the School Districts' policy, and the passage of time, this issue has gone away. It was not even mentioned, that I can recall, at the big public hearing in December except in the context of non-Mello-Roos kids using "their" schools. The Coalition representatives, who have never been affected by the problem, are the only ones beating this dead horse. I guess there's a market for horsemeat.

The benefit of being able to have their homes built at all, and of investing the school system with sufficient capacity to receive their children, seem to me to be fairly direct benefits of paying the tax. I infer from your recommendation No. 6 that that is not sufficiently direct for you. Therefore, I must oppose your recommendation No. 6. Further, I think your recommendation would be an absolute disaster if it were applied to all future Mello-Roos bond issues as opposed to future Mello-Roos districts.

As to your Issue No. 1, I have already generally discussed that. I want to specifically comment on your discussion, under the subheading "Accommodating Multi-Phased CFDs," that some financing decisions should be left to the determination of the voters after the CFD becomes inhabited. You also propose some rather strict rules on differential tax rates for multi-phased CFDs. I would like to respectfully suggest that you are getting out of your depth here (as would anyone who attempts to lay down these sort of rules). There are two issues. One concerns voter approval, and the other concerns differential tax rate formulae.

If certain infrastructure is required before development can be permitted, and the mechanism for supplying that infrastructure is the Mello-Roos, it is patently absurd to make the effectiveness of the Mello-Roos contingent upon future voter approval of the persons who will occupy the development. If the infrastructure really is optional, and is not required before the development can be permitted, then perhaps it should be subject to future voter approval. But in this case, I cannot imagine the developer agreeing in advance to burden his property with that obligation. In most instances the Mello-Roos is a mitigation measure necessary to permit development. It can now be unraveled, after the fact, <u>with</u> the consent of the local agency; but if it becomes subject to unraveling after the fact <u>without</u> the consent of the local agency, no local agency should permit development mitigated by Mello-Roos. The question of what is a proper burden or an improper burden for the Mello-Roos to carry is really a question of what is a proper burden or an improper burden for new development to be required to carry before it can be permitted. That is a question that may require attention, but <u>not within the Mello-Roos act</u>. The Mello-Roos act merely finances what is required in another forum.

A suggestion that might meet the concern you have in this context, and that might be a good amendment to the Mello-Roos act, is to simply require that a time limit be put on the tax. Presently the only statutory limit on the tax is when you finish funding what you have authorized. In many instances we do put a time limit on the tax when we define it, but I do not believe it would be an unreasonable requirement to require every Mello-Roos to set a time limit on the tax, so that a homeowner is told not only the maximum tax, but that it cannot be levied on his property beyond a specified year.

As to the other issue of specifying, in the <u>statute</u>, the exact relationship permitted between developed and undeveloped property, assumes an exactness in the premises that simply does not exist. You are not smart enough, no one is smart enough, to make that kind of a rule in the face of all the possible situations that may occur in the future.

Regarding cross-collateralization, I simply want to take issue with your second paragraph. The only way in which property owners will not be compensated for their subsidization of delinquent taxpayers is when property is not valuable enough to be sold for the amount of delinquent taxes at a foreclosure sale. If the property is sold for less than the amount of the delinquent taxes, then there is a permanent loss of tax revenue to the CFD. But if the property is sold for the amount of the delinquent taxes, the subsidizing taxpayers will be reimbursed in every instance. If the extra tax to cover delinquencies is not put into the reserve fund but is used directly for debt service, then when the tax delinquency is cured, it will not be put into an already full reserve fund, but will be put into the redemption account and enure to the benefit of the taxpayers. If, on the other hand, the extra tax revenue was used to replenish an already depleted reserve fund (as would usually be the case) then when the foreclosure proceeds are received, the reserve fund will again be already full, and again the foreclosure proceeds will go into the redemption fund and enure to the benefit of the taxpayers.

Another possibility is that when the foreclosure proceeds are received, the reserve fund will be depleted by additional delinquencies. In that case the foreclosure proceeds will be put into the reserve fund and there will be no immediate credit back to the taxpayers. But when those additional delinquencies are cured (and remember that these delinquencies bring penalties and interest income with them) they will enure to the benefit of the special tax payers. Eventually the entire reseve fund goes to reduce special taxes. Nothing is ever lost to the taxpayers unless the delinquent property is not eventually sold or redeemed for the amount of the delinquencies.

There are just two more points I would like to make. First, I want to point out that your discussion under "undesirable consequences of tax rate limitations" includes a desire that each local agency be assured that either their service level needs will be addressed or the development will not be permitted to proceed. I agree with this approach, but merely want to point out that it is at odds with your earlier discussion of permitting Mello-Roos taxpayers, after they move into the CFD, to have veto power over the provision of service level needs. If you are able to define the financial responsibilities of local agencies for mitigating service level impact, as you also suggest, you might then have a basis for either prohibiting landowner vote Mello-Roos districts from funding service level needs above that minimum requirement, or providing that any provision of service level needs in excess of that minimum requirement would be subject to the future vote of the Mello-Roos residents.

My last point concerns the proposed 3:1 ratio requirement. As you point out, this has more or less been the standard, and I would not think it a terrible thing if this were adopted. But this is an area where I feel the market is uniquely qualified to set the standard, and far more qualified than government. Just a few months ago the market was demanding 4:1. In that environment it might have been the case that some 3:1 deals would have been done because, if the 3:1 requirement had been adopted, the government could be said to have "blessed" that ratio, where the deal otherwise would not have been done. There may well be situations in the future where the market, in its flexible wisdom, would accept a less than 3:1 ratio in a situation where it were appropriate to do so. Again, I do not believe that anyone is smart enough, including government, to anticipate everything within the scope of some broad, inflexible rule. Sometimes that's just too bad; politics demands it and I understand that. But I do not believe politics really demands it in this case, and if such a rule were adopted I believe it would actually tend to work against the possibility of having uniform appraisal standards, which I think would be far more valuable.

Thank you so much for giving me the opportunity to comment on this report. There is no question that the general effort is very valuable and very constructive.

Very truly yours,

STURGIS, NESS, BRUNSELL & SPERRY
a professional corporation

Daniel C. Bort

DCB\blq

MELLO-ROOS IS A FAIR MEANS OF FINANCING SCHOOL CAPACITY FOR NEW DEVELOPMENT

Daniel C. Bort

Some citizens who reside in Mello-Roos community facilities districts covering new development, and who thus pay special taxes not paid by the community at large, are questioning the fairness of Mello-Roos. The issue seems to be most acute when schools are being financed.

It is not a happy prospect to contemplate a room full of angry Mello-Roos taxpayers and a local school board faced with the choice of either angering them further by refusing to give them special tax relief, or dooming the school district (and the angry Mello-Roos taxpayers and all the *other* citizens of the school district) to inadequate schools.

In a recent public meeting a woman stood up and said, approximately:

> "All I know is I pay the Mello-Roos tax and my son goes to the New School, and my friend Sally doesn't pay the Mello-Roos tax, and her son *also* goes to the New School; and *that's not fair*. We're the only ones paying for the new schools, but *everyone* is using them. We're willing to pay our fair share, but this isn't fair."

To *compound* the feelings of unfairness, some Mello-Roos taxpayers *will not even be getting new schools in their neighborhood*, while some children whose families do not pay the tax will go to the new schools.

The question can be considered in three parts: (1) the fairness of requiring new development to "pay its own way" with respect to schools; (2) the fairness to Mello-Roos families who do not actually get new schools in their neighborhood, and (3) the fairness of the financial impact of Mello-Roos.

Part (1). First, recall that a number of California communities went through a period of debate, in the last decade, whether they should grow at all. In several of those communities the result was a decision to allow limited growth *provided the new growth paid for the necessary expansion of the community's infrastructure*. For example, if the sewage treatment system is already operating at full capacity; and its capacity must be expanded by 5 million gallons per day to accommodate the new development; that new development must pay for that expansion.

That does not seem unreasonable. Whether it is, in some *absolute* sense, "fair" -- can be left to theorists. In a *practical* sense it *is* fair, because it is the "deal" that the developing property owners accepted when they obtained approval to develop. No one forced them to develop; they voluntarily accepted the obligations specified, and without that acceptance no development would have taken place. Today's home owners, in essence, stand in the developers' shoes. No one forced them to buy their homes. They accepted the "deal" when they bought their homes. It is fair to hold them to that deal.

This is also the answer to those who might claim they were deprived of their right to vote on the obligation. They voted with their feet – when they came to the area. It is the same as if a general obligation bond were passed by city-wide vote the year before. The new resident did not get to vote on the tax, but the new resident must pay the tax. The new resident necessarily accepts the tax by coming to the area, and can avoid it by not coming to the area.

New residents do not generally complain when the "deal" involves adding 5 million gallons per day to the capacity of a sewage treatment system. If it's adding 5,000 *students* per day to the capacity of a school system, however, the perception is different. This may be because the practice of having new growth pay its way is unfamiliar to us in the school context, or because treatment plants are more or less invisible, and schools are not. No one is concerned whether their sewage is going to the "old" capacity or the "new;" or that some "old" residents' effluent may actually be treated by the "new" capacity. Everyone recognizes that the new capacity, *however* actually utilized by the public works people, has "created" or "freed up" capacity in the *system* to permit the new development. No one says "We're the only ones paying for the new capacity, but *everyone* is using it. We're willing to pay our fair share, but this isn't fair." There is no intention here to equate schools and sewage treatment plants; but there is no readily apparent reason why, conceptually, the "pay your own way" principle should apply to one and not the other.

Part (2). This has application to the second question about proximity to the new schools. Suppose a new subdivision will generate 30 elementary schoolchildren, and it forms a Mello-Roos district to build one classroom at the local elementary school. It has mitigated its impact on the school through the Mello-Roos district, even though those specific 30 children will not all (and perhaps none of them) actually attend class in *that room*. The construction of the classroom will have "created" or "freed up" 30 classroom places within the school which will be available for the new children. Query: In this situation would it be appropriate to let none of the "old" kids into the "new" classroom because they hadn't paid for it; or to let none of the "new" kids into the "old" classrooms because their properties had paid only a negligible amount for those? No. The new residents have, in effect, "bought-in" to the entire school by expanding its capacity to accommodate their arrival; and the "old" residents have, tacitly, accepted the new classroom as a fair exchange for allowing the new people to use the pre-existing facilities.

This practice and principle has application when more than a single classroom is built. If a new subdivision pays to help build new schools which, for planning reasons, are not nearby; it has nonetheless "created" or "freed up" classroom space in the school *system* to mitigate the impact of the arrival of its children, even though they will not attend the new schools. The impact on the need for school capacity is the same wherever the subdivision is located, and without the mitigation, the subdivision would not have been permitted. The Mello-Roos tax needs to be thought of as a means of "buying or expanding *capacity* in the *system*," just as has traditionally been done with other infrastructure systems, such as treatment plants.

It is essential to realize that the "deal" the developers made and the home owners necessarily bought into is *not*: "You pay the tax and in return you get your very own brand new schools (or treatment plants)." Rather, it is: "You pay the tax to expand the school system (or treatment plant) *capacity*, and in return your homes are allowed to be built."

This is the answer to those who argue that because new schools are not near their homes, they receive no "benefit" from the special tax. Their very real benefit is that their homes were allowed to be built, and there will now be classroom space in the school *system* for their children.

Note that Mello-Roos is a financing mechanism only; it does not control school attendance boundaries.

Part (3). The third part of the question is the financial impact of the Mello-Roos tax. When people buy a house in a new development, they are not paying simply for the house, but also for their share of the new water system capacity, sewer system capacity, road, park, school and other systems' capacity that were required of their development. The Mello-Roos tax acts as a pre-arranged financing program for home-buyers for the school-facility portion of the cost of the new home. (Since developers cannot be required to actually build schools or to pay developer fees sufficient to do so, it is rare that the school cost can ever be directly included in the price of the new home). This extra tax payment is fair so long as the buyers are not required to pay that cost *again* in the price of the home.

That will be true if the house costs less than a comparable house without the special tax. In one area a real property appraiser has confirmed that Mello-Roos homes sell for approximately $11,000 less than comparable non-Mello-Roos homes. A recent study by Seidler-Fitzgerald Public Finance found that Mello-Roos financing lowers housing prices by about 12% compared to a project where infrastructure is financed by the developer, resulting in a total annual cost to the homeowner of about 3% less. Refer to the presence of real estate ads and billboards which cry, when such is the case, "No Mello-Roos Tax!" The absence of the tax is being advertised not to anger Mello-Roos taxpayers (although it does), but because the seller desires that its property be more attractive, and hence sell for more, than a Mello-Roos home.

The woman quoted earlier, who spoke at the public meeting, actually confirmed this point in her testimony. She went on to relate how, due to the recession, she had to sell her home. She said there were other homes available for sale in the vicinity which were not subject to the Mello-Roos tax; and the buyers, at the price she wanted, were buying those unencumbered homes instead. She eventually had to cut her price about $15,000 in order to complete a sale.

If that home, after that sale, were to be relieved of the obligation to pay the special tax (which was the objective of many at that public meeting), the buyers of that home would suddenly be handed a $15,000 windfall (that is: the market value of that home would immediately increase by $15,000). The windfall would have to be *paid for* either by financing no new school facilities, or by finding other taxpayers to carry the burden. The first is unacceptable; and the second is unlikely. The persons buying the house for $15,000 less (what may be called the "Mello-Roos discount") *because* they are willing to accept paying the special tax, are not being treated unfairly in any sense when they are told they must *continue* to pay the special tax. Nor is it surprising that longer-term residents may be reluctant to vote to tax themselves in order to confer windfalls on newer residents.

The Mello-Roos tax shows up on the preliminary title report and either on the California State Department of Real Estate Disclosure ("White") Report or on a disclosure statement required to be provided by the developer. Experience has shown that this level of disclosure has generally been adequate. However, based upon discussions with unhappy taxpayers, it is possible that in extremely "hot" real estate markets, and before Mello-Roos was well known, this level of disclosure may not have been effective in every case to generate the full "Mello-Roos discount." Based in part on these discussions, this writer has proposed more vigorous disclosure legislation. The impression remains strong, however, that it was the frenzy in the real estate market and then its sudden drop, rather than any deficiencies in disclosure, that created the perception on the part of some current owners that they did not receive their "Mello-Roos discount" when they bought their homes.

Mello-Roos has been under fire because people are unfamiliar with the concept of new development providing its own school system capacity; and because many homeowners subject to Mello-Roos taxes bought their homes just before the recession and the downturn in the real estate market – and they are now hurting – and they are looking, understandably, everywhere for relief. But the basic conceptual framework behind the use of Mello-Roos in this situation is simply the application, to schools, of the familiar principle of new development paying its own way; and the market compensates the home-buyer by discounting the purchase price to reflect the presence of the special tax. In this application, Mello-Roos is both traditional and fair.

Daniel C. Bort is a member of the bond counsel firm of Sturgis, Ness, Brunsell & Sperry, Emeryville. He has helped to form numerous Mello-Roos districts in Northern California, and has some direct experience with these issues.

RECEIVED
MAR 10 1992
CALIFORNIA DEBT ADVISORY COMMISSION

CBIA
California Building Industry Association
1107 - 9th STREET, SUITE 1060 • SACRAMENTO, CA 95814 • Phone (916) 443-7933 • Fax (916) 443-1960

March 6, 1992

The Honorable Kathleen Brown, Chairwoman
California Debt Advisory Commission
915 Capitol Mall, Suite 400
Sacramento, CA 95814

RE: Mello-Roos Financing in California

Dear Treasurer Brown,

Thank you for the opportunity to respond to the California Debt Advisory Commission (CDAC) on the important issue of Mello-Roos District financing of public infrastructure.

As you undoubtedly know, Mello-Roos districts represent a unique and important tool available to builders and local governments to fund long term infrastructure development in our communities. Without Mello-Roos, many of the public works projects which are necessary for a well-planned, fully functional community would not be possible.

The members of the California Building Industry Association believe that in general, Mello-Roos financing works well and that the people paying Mello-Roos taxes receive the infrastructure and services they expect.

It is obvious that all parties involved in Mello-Roos districts should have access to the information necessary to make good decisions. Disclosure of information to home buyers, land owners, local governments, builders, bond buyers and others can and should be incorporated into law without damaging the basic integrity of the financing mechanism.

Requirements which remove the flexibility of Mello-Roos, however, should be abandoned. Without Mello-Roos, many school districts and other local government entities would rely on up front fees from new home buyers and renters to accomplish what modest monthly payments from those same buyers now accomplish. The up-front fee becomes part of the price of the home for which the buyer must qualify, on which property taxes are paid, and which will be financed at mortgage interest rates rather than the lower Mello-Roos rates.

This would result in a loss of housing affordable to a large range of buyers and renters, an outcome no one believes would be in the best interest of California.

CBIA, a state-wide trade association representing 6,000 firms involved in residential, commercial and light industrial construction in California is composed of 10 regional associations. One of those associations is the Building Industry Association of Southern California (BIASC).

In a detailed report to the California Debt Advisory Commission, the Orange County Chapter of BIASC has comprehensively and effectively responded to the CDAC staff report on behalf of the building industry. To avoid unnecessary duplication of paper work, we refer the CDAC staff to this report for a more detailed analysis.

Should you have any questions about our position, or if you need further information, please do not hesitate to call me at (916) 443-7933.

We look forward to working with you on this and other issues in the near future.

Sincerely,

CLIFF ALLENBY
Senior Staff Vice President for Governmental Affairs

cc: Thomas W. Hayes, Director, Department of Finance
Gray Davis, State Controller
Senator Robert Beverly
Senator Lucy Killea
Assembly Member Jim Costa
Assembly Member Patrick Nolan
Donald W. Mertz, Sonoma County Treasurer/Tax Collector
Mary E. Turner, City of Anaheim Treasurer

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REF. OUR FILE

February 18, 1992

California Debt Advisory Commission
915 Capitol Mall
Room 400
PO Box 942809
Sacramento, Ca. 95814

Attention: Mr. Steve Juarez, Executive Director

Re: CASH Mello-Roos Review Committee Comments On
CDAC Staff Legislative Recommendations

Dear Commission Members:

The Coalition for Adequate School Housing ("CASH") has designated a CASH Mello-Roos Review Committee ("CASH M-R/RC") to review and comment on the California Debt Advisory Commission staff recommendations ("CDAC", "CDAC Staff", and "CDAC Staff Recommendations") relative to possible legislative amendments dealing with the Mello-Roos Community Facilities Act of 1982 ("Mello-Roos Act") and the issues addressed and raised prior to and at the CDAC hearing in Orange County on January 15, 1992, dealing with financing of public facilities and services, including school facilities, by means of a community facilities district ("CFD").

These comments are submitted on behalf of the CASH M-R/RC, including myself, Alexander Bowie of Bowie, Arneson, Kadi, Wiles & Giannone; Dave Doomey of Capistrano Unified School District; and Bruce Kerns of Westhoff-Martin & Associates. These comments in the brief interim period available also were reviewed by staff members of other school districts. The members of the CASH M-R/RC will be present in Sacramento at the CDAC meeting on February 19, 1992, to present these comments, answer any questions in regard to these comments, and as appropriate, take further comments on behalf of CASH. In regard to the experience and qualifications of the members of the CASH M-R/RC, their biographies are attached as Enclosures 1, 2 and 3.

CDAC STAFF RECOMMENDATION #1.

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

CASH M-R/RC COMMENTS ON CDAC STAFF RECOMMENDATION #1.

CASH supports the proposed legislative amendment relative to Recommendation #1 by the CDAC Staff for more timely, definitive and adequate notice to purchasers of residential property. As to the concluding comments relative to "benefit" and school facilities set forth in the CDAC Staff proposal as to Recommendation #1, a suggested alternative approach is set forth in the response to CDAC Staff Recommendation #7.

CDAC STAFF RECOMMENDATION #2.

Establish an Annual Reporting Requirement for Mello-Roos CFDs.

CASH M-R/RC COMMENTS ON CDAC STAFF RECOMMENDATION #2.

CASH is supportive of the enactment of legislation providing for annual reporting requirements as proposed by CDAC Staff Recommendation #2. It would seem logical to include such information as a requirement of the annual audit which is already required of local public agencies by statute. In most such audits explanatory notes currently indicate the existence of such debt, but not the detail suggested. This would be an expansion and more detail relative to the reporting now being accomplished by such annual audits. Any such legislation should immunize a local agency from any liability or litigation relative to the furnishing of such information. Also, as to an existing CFD, this cost would seem to be a reimbursable state mandated cost.

The information as to assessed value should be as of a feasible prior date, such as March 1 of the preceding fiscal year. Also, it would seem appropriate to require the local county assessor to establish tax code areas for a CFD if the boundaries of the CFD have been filed with the county assessor and State Board of Equalization prior to January 1st of the preceding fiscal year. It is our understanding assessment valuations are determined for each such tax code area. This would facilitate ascertaining the assessed value data desired. (In this regard, see Section 54900 of the Government Code.) Also, an amendment to Section 647 of the Revenue & Tax Code may be appropriate to insure the timely availability of such information relative to a CFD without additional substantial cost.

The CASH M-R/RC suggests that it might be more logical in regard to the comments relating to "Development Status", in CDAC Staff Recommendation #2, to revise the comments to read as follows:

> "7. A list of the names and business addresses of all property owners in the CFD who own at least 10% of the assessed valuation of the CFD are responsible for 10% of the total special tax of the CFD."

Also, any required information as to bankruptcy proceedings should relate to owners of property responsible for 10% or more of the special tax of the CFD.

CDAC STAFF RECOMMENDATION #3.

Limit the Maximum Special Tax on Residential Properties to One Percent (1%) of the Assessed Value for Landowner-approved Financings.

CASH M-R/RC COMMENTS ON CDAC STAFF RECOMMENDATION #3.

The CASH M-R/RC suggests that in this regard the CDAC Staff recommendation does not go far enough. A substantial issue that has confronted school districts in many instances is not addressed. In many instances the city or county, being the entity granting land use approvals, will have a captive participant of a developer for its CFD and will utilize the entire 1%, leaving school facilities unfunded. In many instances excessive amounts of regional facilities are funded by a CFD but the developer refuses to fund school facilities, as the standard 1% has been used up for long range future facilities or development costs usually funded from acquisition and development loans ("A/D/Ls") or construction loans ("C/Ls"). As indicated in subsequent CDAC Staff comments, the available 1% in instances has been used for financing facilities which can otherwise be funded. The CASH M-R/RC submits that in some instances CFD financing resources are used to fund fees and other costs normally funded by A/D/Ls or C/Ls obtained by the builder or developer while school facilities are left unfunded. Also, these facts make a subsequent local school bond election pushing local taxes in excess of 2% a futile gesture. The CASH M-R/RC suggests that an amount in the magnitude of approximately 50% of the proposed permitted 1% additional special tax be set aside for funding school facilities unless school facilities are otherwise funded by the developer, the community through local bond elections, the State of California, or the consent to encroach thereon has been granted by the school district prior to the formation of a CFD.

This amount plus statutory school fees presently in the amount of $1.65 per square foot of assessable area per dwelling unit ("D/U") might reach 80% to 90% of the cost of school facilities per D/U. This conclusion will vary based on land cost for school sites, varying from $60,000 to $1,000,000 per acre. The recommended solution suggested by the CDAC Staff Recommendation #3 does not address this inequity to school districts, and the negative effect on local school bond elections when the 1% is used up without considering the funding of school facilities.

Additionally, the CASH M-R/RC suggests that the CDAC "Planning Guidelines" and the fourth unnumbered paragraph in Page 9 of the CDAC staff proposal be amended to read as follows:

> "For this reason, we continue to recommend that local governments adopt the "Planning Guidelines" outline in the CDAC report (see pages 57-59). Essentially these guidelines require cities, and counties <u>and school districts</u> to review..."

There is no indicated rationale for excluding school districts from such determination. The cost of school facilities is a major component of the public facilities costs resulting from new development and should not be excluded from such decision. In this regard, please see pages 26 and 27 of the "1991 Capital Outlay and Infrastructure Report" of Thomas W. Hayes, Director of the State Department of Finance. The face sheets and pages 26 and 27 are enclosed for your review. At page 27, you will note it is stated:

> <u>"After 1992, the remaining $6.4 Billion in identified funding is estimated to be a local responsibility".</u>

As to the $1.9 Billion dollars of bonds proposed for the June primary election ballot, there are an estimated $6 Billion dollars of applications on file with the State Allocation Board ("SAB") and in excess of approximately $1.6 Billion dollars of approved but unfunded school construction projects ready to go to bid after a favorable June election. The results of local school bond elections at the general election in November of 1991 was a dismal and discouraging defeat for 83% of such local bond elections (29 of 35 local bond measures failed). Hence, landowner approved CFD funding of local school facilities seems to be the last available resource to the extent the present $1.65 per square foot of assessable area funds only 20% to 30% of such costs. Hence, the only available alternative is required concurrent availability of school facilities mandated when non-urban property is rezoned for development pursuant to the Mira/Hart/Murrieta decisions hereafter discussed, with funding of such obligations by land owner authorized bonds of a CFD. The CDAC Staff correctly points out that this should be done in a fair and equitable manner as to burden and use of the resulting school facilities with adequate notice to all prospective purchasers.

CDAC STAFF RECOMMENDATION #4.

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

CASH M-R/RC COMMENTS ON CDAC STAFF RECOMMENDATION #4.

CASH is supportive of the proposed legislation limiting the annual increase in the maximum special tax on residential properties to two percent (2%) after issuance of building permits for landowner-approved financings, provided 50% of the 1% is set aside for funding of K-12 school facilities unless the consent of the school districts is obtained. However, the increase of the special tax may have to be greater than 2% per annum prior to issuance of building permits to cover increases in costs of land acquisition and school facility construction.

CDAC STAFF RECOMMENDATION #5.

Require the Issuing Agency to Have a Substantial Interest in the Facilities and Services Funded Through the Special Tax.

CASH M-R/RC COMMENTS ON CDAC STAFF RECOMMENDATION #5.

The CASH M-R/RC's recommendation is that the prohibition proposed by the CDAC Staff be modified and adopted. The modification would be that rather than there being a specific prohibition of an agency acting as the conducting authority in the CFD proceedings where the amount to be financed is less than any other entity for whom facilities are being financed through a joint financing agreement, there should be an opportunity for that entity to act in such regard subject to obtaining the approval of the State Treasurer. The legislation in this regard could be on a "no action" basis that appropriate information would be filed with the State Treasurer and it would be deemed to be approved if no response is received within a specified period. However if such request does not appear appropriate, the State Treasurer would then take jurisdiction for consideration of either a specific approval following deliberation and additional factual information being submitted or such a request would be denied by the State Treasurer. The specifics of such procedures could be provided for by promulgation of appropriate regulations. This procedure might be a streamlined version of the procedures formally existent relative to the Districts Securities Advisory Commission to the State Treasurer. It should be noted that during the approximately 60 years of such function being accomplished by the State Treasurer and the predecessor, the California Districts Securities Commission, no bond ever issued after such approval ever experienced a default. This result may give credence to the applicability of such function through the State Treasurer to this issue and other issues relative to financing by CFDs under certain, but not all, circumstances. If on the one hand a procedure produced no defaults in 60 years and various CFD financings without such oversight have produced defaults in a short period of time, a comparison of the two procedures by CDAC would seem appropriate.

CDAC STAFF RECOMMENDATION #6.

Require that Substantial Redirection of Funds be Subject to Referendum.

CASH M-R/RC COMMENTS ON CDAC STAFF RECOMMENDATION #6.

The CASH M-R/RC is supportive of proposed legislation in regard to Recommendation #6 with modifications. This should not be an absolute prohibition if the modification is in excess of 10%. Such a change in excess of 10% should require a noticed public hearing and provide for a majority protest terminating the right to modify the utilization of the financing that has been authorized as opposed to an election. The existing procedure of the Mello-Roos Act set forth at Section 53335 of the Government Code would appear to be adequate in this regard.

CDAC STAFF RECOMMENDATION #7.

Require that Facilities and Services Funded Through the Special Tax Provide a Direct Benefit to CFD Residents.

CASH M-R/RC COMMENTS ON CDAC STAFF RECOMMENDATION #7.

It is the recommendation of the CASH M-R/RC that an approach be pursued other than the "benefit" approach suggested by the CDAC Staff relative to the manner in which school facilities funded by means of a CFD are to be utilized.

The "benefit" approach is not feasible relative to school facilities for grade levels above either K-6 or K-8, depending on the local grade level configuration. While home owners in a CFD justifiably would expect access to neighborhood K-6 or K-8 school facilities funded by the CFD in or near their residence, middle schools or high schools in many instances are not located in or near the particular CFD, or there is more than one choice in which seating capacity exists with varying attendant busing or access costs. The "system purchase" approach referred to in the CDAC Staff Recommendations is the only feasible alternative for grade levels K-12. However, documentation of attendance policies of the school district should be set forth in the CFD proceedings and the notice to purchasers.

The CDAC Staff proposal as to Recommendation #7 and a statutory vested right for attendance in a specific school facility for students residing in a particular CFD would appear to raise Constitutional issues as to reasonable equal public availability to all public facilities and usurps the authority of the governing body of the school district, and impairs its ability to react to changing circumstances in the future.

The availability of such facilities, the financial contribution of the homeowner through the CFD and issues as to policies of a school district relative to attendance boundary policies are proper questions that need to be answered. It may be appropriate to enact statutory provisions for inclusion in resolutions of intention and formation of a CFD as follows:

> "To the extent consistent with applicable law, the District shall establish and maintain attendance boundaries in a manner to permit students residing within the CFD to attend the school facilities substantially funded with special tax or bond proceeds of the CFD. The foregoing shall be construed, if necessary, consistent with the obligations and authority of the District to establish reasonable attendance boundaries to provide equal quality education to all students of the District."

The foregoing would be in lieu of any suggested enactment of determinations of "benefit". As noted by the CDAC staff, the need to deal with this issue also relates to the notice provisions discussed in CDAC Staff Recommendation #1.

As to the portion of the CDAC Staff Report dealing with "Other Issues", the comments of the CASH M-R/RC are as follows:

CDAC OTHER ISSUE #1

The Subsidization of Developers by Homebuyers in Mello-Roos CFDs.

CASH M-R/RC COMMENTS ON CDAC STAFF ISSUE #1.

The CASH M-R/RC understands the CDAC Staff's concern as to whether undeveloped property should be taxed in a manner comparable to developed property. However, it is not noted by the CDAC Staff Report that prior to the decisions in Mira Development Corporation, et al., v. City of San Diego, et al., 205 Cal.App.3d. 1201, William S. Hart Union High School District v. Regional Planning Commission of the County of Los Angeles, et al., 277 Cal.Rptr. 645, Cal.App.2 Dist. 1991), and Murrieta Valley Unified School District v. County of Riverside, 279 Cal.Rptr. 421, Cal.App. 4 Dist. 1991), herein ("Mira, Hart and Murrieta decisions"), many cities and counties refused to consider school facilities as part of the land use and entitlement process. Hence, the carrot extended by the school districts in lieu of adversarial nonproductive litigation was to bring school facilities on line concurrent with development by means of CFD funding. This was determined to be justification for providing capitalized interest above the fiscal requirements accruing prior to the receipt of special tax proceeds. This approach resulted in the funding of school facilities when the State of California had defaulted on its commitment expressed in the 1986 School Facilities Legislation ("AB 2926"). Assuming the Legislature does not tamper with the holding of the Mira, Hart and Murrieta decisions as previously proposed by the California Building Industry Association ("CBIA") and others, a requirement that the special taxes be levied and collected equally on developed and undeveloped property is not objectionable when there is not to be a series of bond issues over time. The CDAC Staff Recommendations may have the effect of making entry level housing less available and be contrary to seeking to stimulate the home building sector of the California economy. The CDAC Staff Recommendation is fair in the sense of equalizing the specific local burden of a CFD, but should consider these other possible effects as well. Any such legislation might grandfather property having received land use entitlements prior to January

1, 1995, or some other date to avoid the possible inequity of changing the rules in midstream as to property already acquired for development purposes.

The example in Lake Elsinore Unified School District referred to in the Orange County CDAC hearing was not fully explained to CDAC and left an erroneous impression. The developer in that instance otherwise would have paid less than $1.50 per square foot of assessable area, or less than $2,000 per dwelling unit ("D/U") by reason of a preexisting agreement with the predecessor high school district. The developer, Presley of Southern California, funded approximately $6,000 per D/U and delivered the funds through a CFD to construct the K-6 school facilities prior to exceeding approximately 250+ students. Other developers in the area were refusing to cooperate with the school district. This obviated substantial interim classroom costs and established a minimum financial contribution expected of future development in the school district. This agreement included a reimbursable advance of architect fees to expedite construction. The special tax of the CFD in that instance related to no more than approximately 70% of each D/U's estimated share of the cost of the K-12 school facilities estimated to be ultimately required for housing students from each such D/U. This seems sound and equitable. It should also be noted that the CDAC Staff's conclusion expressed relative to 12 D/U to the acre was in fact 2-1/2 D/U per gross acre. While the CDAC Staff's mathematical conclusions were in error, this is an agreed issue deserving of further review in light of this sole available means after 1992 for funding of K-12 school facilities.

As to a CFD where bonds will be issued in several series, experience indicates that the tax level which will exist on issuance of all debt should be imposed at the outset. However, to the extent this exceeds the existing debt service possibly any amount relating to debt not issued might be held and used to reduce the amount of bonds to be sold. The effect of this if applied also to undeveloped property would seem to be contrary to expressed policies of the Legislature to facilitate economic activity in California. Also, it may be desirable to project an effective date of any such change for a period of three or more years.

It is a strong possibility that restricting a school district's ability to make concessions as to how and when undeveloped property is to be taxed might have a disastrous inhibiting effect on negotiating agreements with developers to provide funds on a timely basis to build school facilities that the CBIA and developers view as a defaulted responsibility of the State of California.

2. The Cross-Collateralization of Property in CFDs.

The CASH M-R/RC concurs that this is an issue deserving of attention. The effect, however, of the suggestion may be to unnecessarily increase taxes or CFD financing costs on all homebuyers. The first-time homebuyer in such event will be further squeezed from the prospect of home ownership. This is contrary to previously expressed legislative policies. Investment bankers and underwriters will require the levy of taxes in excess of actual debt service unless the ability to do so in the event of default by others exists. Hence, it will have to be levied as opposed to held in reserve. As indicated by the CDAC Staff proposal, the solution may be legislation dealing with reimbursement when the defaulted special taxes are paid. This approach seems preferable.

3. The Capitalization of Interest.

The CASH M-R/RC submits that the so-called "free ride" of two years in some instances may be justified and help meet the past default of the State of California as to its AB 2926 obligation to fund school facility costs after January 1, 1987. Even the partial funding by the State of California to date is proposed to be eliminated as set forth at page 27 of Mr. Hayes' report, included as Enclosure No. 4. Hence, the ability to make such a concession may have a much greater benefit to education in the particular school district. Uniformity of policy and consistency as to the financial obligations of future developments for funding of school facilities is a major point for consideration as to this issue. Landowner approved CFDs by or for school districts are the only present source of funding and reasonable help to the developer in the front end of project expenses, and may be desirable if the school burden is being accepted by the developer. Assuming the Mira/Hart/Murrieta decisions are not altered by the Legislature, limiting capitalized interest to what is necessary from date of issuance to receipt of special tax proceeds is a sound proposal. However, a limited and arbitrary amount of capitalized interest would tend to force all CFD bonds to be issued during a several month interval each year. The amount of capitalized interest permitted should relate to fiscal needs from date of issuance to receipt of special tax proceeds. The maximum amount of capitalized interest should be no less than 18 months.

CDAC STAFF ISSUE #2.

The Need for Uniform Land Appraisal Standards

The CASH M-R/RC concurs in this CDAC Staff Recommendation, but feels it should go further. The CASH M-R/RC suggests that any such legislation specify that all requirements of the Political Reform Act ("PRA") be satisfied so that not only the appraiser but the party preparing the market study and the special tax formula for a CFD financing and the bond counsel meet all requirements of the PRA and not be the recipient of "income" as defined in the PRA from the developer in the 12 months preceding any decision relative to a CFD or the sale or issuance or bonds. The CDAC Staff Recommendation as broadened by the CASH M-R/RC's suggestion seems consistent with the spirit of the recently released "A User's Guide to Conflict of Interest Rules for Public Finance Transactions" prepared and published by the State Treasurer. We suggest a more specific additional step as to special tax consultants and bond counsel as opposed to just the appraiser.

CONCLUSION

These comments of Messrs. Bowie, Doomey and Kerns are respectfully submitted They may not be the view of all school districts or school district members of CASH, but have been exposed to the staff of various school district members of CASH in the minimal period of time available. In light of the limited time available to consider the CDAC Staff Recommendations it is respectfully requested that no action be taken by CDAC on this matter on February 19, 1992, but that the matter be held and all comments received be reviewed and further comments be solicited for a period of 60 days.

CASH and the CASH M-R/RC look forward to a continuing effort with the CDAC and its staff to insure availability of CFDs as a means of funding school facilities in a fair and equitable manner consistent with maximum public benefit at the least possible cost to the taxpayer. We appreciate the opportunity to submit these comments.

Respectfully submitted,

BOWIE, ARNESON, KADI,
WILES & GIANNONE

By
Alexander Bowie

AB/fb
Enclosure
cc: Mr. Mike Vail, President/CASH
Mr. Jim Murdoch/CASH
Mr. Dave Doomey/CASH M-R/RC
Mr. Bruce Kerns/CASH M-R/RC

Mello-Roos

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CALIFORNIA DEBT
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Fieldman, Rolapp & Associates

INDEPENDENT FINANCIAL ADVISORS TO LOCAL GOVERNMENT

William L. Fieldman
R. Michael McNamara
Lawrence G. Rolapp
Principals

February 11, 1992

Mr. Steve Juarez, Executive Director
California Debt Advisory Commission
915 Capitol Mall, Room 400
Sacramento, CA 94209-0001

Dear Steve:

Thank you for the opportunity to participate in the candid discussion regarding the Mello-Roos Hearing Report and the recommendations and issues surrounding community facilities districts. I truly believe that the changes and ideas that have been expressed regarding Mello-Roos over the last several months will result in positive legislation for issuers, property owners, and investors.

As a broad statement, the recommendations and ideas that were presented in the draft staff report to CDAC regarding recommendations and issues has covered many of the major issues of concern. Many of the items that the TAC members discussed focused on technical issues. However, there were some fundamental items that are worth your consideration.

Recommendation No. 1 - Disclosure to first time home buyers and subsequent home buyers might appropriately be different. Strong consideration should be given to residential resales offered through local Realtors or "For Sale By Owner." It is extremely difficult to believe that those sellers participating in these types of transactions will be able to comply with the disclosure that is contemplated in Recommendation No. 1. Therefore, a reduced amount of resale disclosure might be better, with resale purchasers referred to additional information on file at CDAC, given Recommendation No. 2.

Recommendation No. 2 - The extensive list of items proposed to be provided annually to CDAC will place an extensive financial burden on local government and special tax payers. Notwithstanding the foregoing, the information outlined under the "Capital Project Status" and "Financial Status" is information that could be readily compiled and provided to CDAC. However, the information under "Development Status" is more difficult. While a lengthy discussion ensued at the TAC meeting concerning the aspect of a cottage industry, it still becomes an economic and human resource burden for public agencies to compile "Development Status" data. In addition, much of the information that is outlined in the "Development Status" will either not be available on a timely basis or misses the mark (i.e., assessed valuation when greater concern should be given to issues surrounding percentages of special tax obligation).

It is my understanding that much of the "Development Status" information would be used to provide secondary market disclosure to bond investors. It is also my understanding that the Public Securities Association is currently in the process of doing a study to determine if they can retrieve and preserve this information through their own data bank. It would be my recommendation that the information under "Development Status" be deferred until legislation is put into effect dealing with the issues under "Capital Project Status" and "Financial Status." As you well know, each year additional legislation for Mello-Roos is introduced and it might be more advantageous to put in place a reporting system that is less burdensome in the beginning.

Recommendation No. 3 - John Murphy, was extremely articulate on his concern with respect to the approach that would be used to limit the special tax on residential properties to one percent

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(1%) of the assessed value. As I am sure you are well aware, the one percent (1%) limit discussed in this recommendation is usually done as part of the original creation of the special tax. However, as is currently being seen, anticipated sales prices change and land use changes, required by local government can occur subsequent to the creation of special tax. This will be an extremely difficult issue to put into statute, but I certainly support the concept and our firm avtively participates in community facilities districts where caps with these limits is part of the planned structure.

Recommendation No. 4 - It should be understood that if this recommendation is put into statute, much of the cross collateralization that is provided through a back-up special taxes disappears. Land use changes or high special tax delinquencies can cause insufficient revenue to be generated, risking temporary or permanent bond defaults.

Recommendation No. 5 - This is a good solid recommendation.

Recommendation No. 6 - Cost over-runs and/or the infusion of outside funds can cause major deviations from the estimated costs of facilities outlined in the Resolution of Intention. Instead of implementing this recommendation, I would suggest that a list of facilities be provided as part of Recommendation No. 1 to home buyers, so that they are aware of the facilities that may be funded within a community facilities district and then the buyers can make an intelligent decision of whether or not to purchase within the CFD.

Recommendation No. 7 - This provision is extremely difficult for school districts. Mello-Roos, one of the few viable financing tools, may be unusable for school districts that cannot, by policy, assure new homeowners within a community facilities district that they would be entitled to attend specific schools built with CFD funds. Other than schools, it does not appear that any other practical problems would occur with this recommendation.

As I stated at the TAC meeting, another issue for serious legislative consideration would include a standardized procedure for appraisals (Issue No. 2). In addition, I would support a limitation of capitalized interest to a maximum of one (1) year.

I hope the foregoing is valuable to staff in preparing its report to the CDAC and if I may be any further assistance, please do not hesitate to contact me.

Sincerely,

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March 5, 1992

California Debt Advisory Commission
915 Capitol Mall, Room 400
P.O. Box 942809
Sacramento, California 94209-0001

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ADVISORY COMMISSION

Attention: Steve Juarez
Executive Director

Ladies and Gentlemen:

We appreciate the opportunity to comment on the recommendations and discussion of issues contained in the CDAC Report On Proposed Legislative Changes to the Mello-Roos Act (the "CDAC Report") discussed at the California Debt Advisory Commission ("CDAC") meeting on February 19, 1992 (the "Meeting"). Although there will be other times and forums to discuss the CDAC recommendations once they have been transmitted to the State Legislature, we believe that the Legislature will, and should, give great weight to the thoughtful study and presentation of the issues made by CDAC. Thus, input at this stage is much more likely to affect the eventual legislation than input at any other stage of the legislative process.

We would also like to take the opportunity to commend the CDAC professional staff for the excellent job they did in bringing together the diverse group of commentators at the January 15, 1992 hearing on Mello-Roos held in Orange County (the "Hearing") and in creating a report for consideration by CDAC and the Legislature. The appropriate use of Mello-Roos is a complex issue, and it was difficult to distill the numerous points made at the Hearing into a comprehensive and compact presentation. In synthesizing the Hearing testimony into a set of definable issues, the CDAC staff has done a monumental task in a short period of time.

The purpose of our letter is to discuss certain of the issues and recommendations raised in the CDAC Report, with the hope that we can suggest some new avenues of inquiry. The members of the development community whom we represent have their own significant, first-hand experience with Mello-Roos, and they are grateful that CDAC is willing to give their concerns thoughtful consideration. Our clients understand and agree that in the current environment, certain policies should be adopted to make use of Mello-Roos more acceptable, especially in light of its recognized usefulness and contributions.[1]

As a preliminary matter, we note that several of CDAC's recommendations impose a greater burden on agencies relying on Mello-Roos financing than on agencies using other comparable public financing techniques. Because policies should be adopted that work toward eliminating perceived, as well as actual, shortcomings associated with Mello-Roos,[2] additional burdens may be appropriate. However, such policies should only be adopted if the resulting costs do not outweigh the benefits of these new policies. We respectfully request, therefore, that CDAC perform such a cost/benefit analysis when it reviews its recommendations in light of the comments it receives.

For ease of reference, we have repeated the relevant CDAC recommendation (or issue statement) in italics and followed it with our comments.

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1. For example, at the Hearing, California State 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."

2. CDAC Report, Finding #1.

CDAC
RECOMMENDATION #1

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

Consequently, we recommend that the Legislature amend the Notice of Special Tax requirement 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 will apply to both the initial sale of homes in new CFDs and subsequent sale of homes in CFDs. It will not be necessary to update the original Notice of Special Tax for secondary buyers.

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, special assessments, and special assessments on the parcel.

(2) A statement that the buyer should consider the higher annual tax payments associated with the property when formulating his or her bid price.

(3) The amount of the maximum special tax which may be levied on the property and the duration of the special tax.

(4) In cases where developed and undeveloped property will be taxed at different rates, a brief description of the special tax formula. The tax burden on developed property shall be converted to an acreage basis, based upon the density of dwelling units per acre, to provide a comparison between the developed and undeveloped tax rates according to a common unit of measurement.

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

(6) 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. In addition, should the Legislature choose not to implement the requirement that Mello-Roos taxpayers receive a direct benefit from all facilities and services funded through their special tax payments (see Recommendation #6), we recommend that the Notice of Special Tax also disclose that the buyer's special tax payments may be used to construct facilities which the buyer may not be permitted to utilize.

Recommendation Comments:

The developers whom we represent generally applaud the expansion of disclosure and the delivery of disclosure at an earlier time. As you know, the Orange County BIA is working on a standardized draft disclosure form which we hope you will seriously consider.

This recommendation applies to both initial sales and subsequent sales of homes in CFDs, yet the recommendation may not accurately reflect the way the resale market operates. In most resale cases, the buyer presents the seller with an offer which the seller accepts or rejects. The seller's acceptance transforms the offer into a bilateral contract to sell and purchase. As a result, it is unclear whether the recommendation as currently formulated for resale can be easily administered or monitored. In the written testimony we presented at the Hearing, we presented a possible solution to this dilemma. We recommend that the disclosure be made in the Real Estate Transfer Disclosure Statement, which is required to be provided by a homeowner to a subsequent purchaser. A prospective buyer has certain rights to invalidate a purchase contract based on the information disclosed therein. While this is not as beneficial as receiving the notice before a bid is made, it works within the existing resale practices and has the benefit of permitting a prospective buyer to reconsider his or her purchase because of the Mello-Roos tax levy on the property.

The other issue which must be considered is whether disclosure developed at the time a home is first sold will be appropriate or accurate when that home is resold in ten or 20 years. Because certain aspects of the disclosure (such as cost estimates for facilities and services) may change over time, we recommend that the Notice include a statement that the Notice of Special Tax has not been updated since its original issuance and that more current information may be obtained from the CFD.

Paragraph 2 of this recommendation does not take into account two scenarios common in today's housing market: 1) the use of an auction to sell homes in a new subdivision and 2) the fact that home prices may be set by the developer after taking the present value of the special tax into account. Both of these variations deserve mention in the introduction to this recommendation and consideration in the language of paragraph 2 as discussed below.

The disclosure required in paragraph 2 seems to assume that the sales price for a home is never discounted by the existence of the Mello-Roos tax. In fact, in the current market, sellers do often discount the asking price for their homes because of a Mello-Roos tax. As worded, paragraph 2's disclosure requirement would provide a disincentive for this current seller's practice because of an increased likelihood that home purchasers would attempt to negotiate even more aggressively for an additional decrease in the already discounted sales price. Given a general change in negotiating strategy, a seller may be wise to discontinue a current practice of discounting the asking price, so that it is prepared to reduce the price if the issue is subsequently raised by a potential buyer.

In addition, many factors must be considered in determining a sale price, only one of which is the infrastructure improvements required to mitigate the impacts of new development. Thus, it is not unusual to find what appear to be comparable homes in an area priced differently. The disclosure required by paragraph 2, however, may cause buyers to over-simplify the pricing process. Accordingly, we recommend that paragraph 2 be expanded to acknowledge other factors that affect the pricing of homes. These include, but are not limited to the quality of the location, school district, open space and parks, access to public transportation and other public amenities; and the existence of other assessments and liens.

The disclosure requirement set forth in paragraph 3 should be clarified to reflect the fact that some taxes for incremental services are perpetual. Additionally, Mello-Roos taxes are usually structured to include minimum and maximum tax levies. The actual tax levied is often in between the minimum and the maximum, and the homebuyer should be provided with information about the authorized tax range. Thus, we recommend that paragraph 3 be amended to read: "The minimum and maximum amount of the annual tax authorized and the duration of the special tax which may be levied on the property for bond repayment and the amount and the duration, including whether it is perpetual, of any special tax which may be levied on the property for services."

A description of the special tax formula is appropriate. However, the requirement set forth in paragraph 4 to compare the undeveloped property tax rate and developed property tax rate on an acreage basis is not. The developed property tax rate reflects the fact that residents of developed property utilize the infrastructure far more heavily than owners of undeveloped property, and taxing heavy users more than light users is fundamental to many taxing approaches. Additionally, taxing developed property at a greater rate increases the credit-worthiness of Mello-Roos bonds by providing a diversified tax base. Additionally, the disclosure required in paragraph 4 could be materially misleading, since taxes on undeveloped land often vary dramatically during development as Mr. Taussig's example at the Hearing demonstrated. Finally, assuming the requested disclosure was to be made, it is unclear what exactly should be compared. Should the maximum taxes per developed acre be calculated assuming only development of the particular kind of unit being sold (as opposed to other allowable units in the development)? For all these reasons, we recommend that the second sentence of paragraph 4 be deleted.

Paragraph 5 should be amended to accommodate the situation in which a CFD approves several pieces of infrastructure for construction, with the knowledge and intent that not all of them will be financed. Because of the value-to-lien ratio requirements and other constraints of the marketplace, the actual dollar amount of bonds might be less than that approved. Additionally, because bonds are often issued during the design process, infrastructure descriptions and costs may change. We therefore recommend that paragraph 5 include statements regarding whether bonds have been issued for the full amount of approved projects, which projects (if any) have funding priorities or are alternatives, and the fact that the final determination of the items which will be financed with Mello-Roos had not yet been made.

In addition to paragraphs (1) - (6), we also recommend that the Notice of Special Tax include a description of how the special tax may be prepaid, a prepayment provision has been included in the method and rate of apportionment of special tax.

RECOMMENDATION #2

Establish an Annual Reporting Requirement for Mello-Roos CFDs.

Consequently, we recommend that the Legislature establish an annual reporting requirement 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:*

Development Status

1. *Number of residential properties developed.*

2. *Square footage of commercial and industrial properties developed.*

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

4. *Number and value of properties sold.*

5. *Vacancy rates of commercial/industrial properties.*

6. *Percent of CFD developed by land use classification.*

7. *A list of the names and business addresses of all property owners in the CFD who own at least 10 percent of the assessed valuation of the CFD.*

Capital Projects Status

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

2. *Fund balances in construction accounts.*

Financial Status

1. *Reserve fund balance.*

2. *Capitalized interest fund balance.*

3. *Tax delinquency rates.*

4. *Foreclosure actions.*

5. *Outstanding principal and interest amounts.*

6. *Debt authorization levels.*

7. *Overlapping tax rates.*

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. Neither the reporting local agency or CDAC shall be liable for reporting inaccuracies.

Recommendation Comments:

Requiring secondary market disclosure on a particular municipal security is costly and cumbersome, and the general need for such disclosure is hotly debated in the municipal bond community. This recommendation burdens the issuers of Mello-Roos bonds with these costs by statute, while other municipal instruments are not so burdened. Although it would be preferable for State funds to be used to finance the cost of compiling and distributing this information, it is unlikely such funds would be available in light of the current fiscal crisis. Therefore, the cost of satisfying this disclosure requirement should be financeable with Mello-Roos proceeds. Because such costs result in less money being available to finance infrastructure, only disclosure directly beneficial to bondholders in the secondary market should be required.

The necessary disclosure may be less than that set forth in the recommendation, since the majority of Mello-Roos bonds are held by sophisticated investors. In light of the expense of secondary market disclosure and the institutional nature of Mello-Roos bond purchasers, we think it is important that representatives of the current bond holding community review and comment on this recommendation. Such representatives can provide insights into what information may be useful (which may vary depending upon the stage of development), and yet be sensitive to the associated costs. For example, once the value-to-lien ratio exceeds five or ten to one, it is very possible that the secondary market would no longer be interested in vacancy rates and square footage numbers.

The recommendation seems to identify CDAC as the central repository of secondary market disclosure. If this is the case, several questions remain unanswered, such as how CDAC is going to distribute the information and how CDAC's disclosure services will be funded. It may be more cost effective for the administrator of the CFD to compile the requested information and deliver it, along with the annual information required to determine the special tax levy, to the Board of the CFD and, if Mello-Roos bonds have been issued, to the Bond Trustee. The Bond Trustee (or if there is none, the CFD Board) could distribute the information to investors or others upon request. This suggestion helps minimize the expense of secondary disclosure because much of the recommended information must already be compiled to determine the annual special tax levy. For similar reasons, we recommend that the recommended information be provided concurrently with or shortly after determining the annual special tax levy instead of at the conclusion of each calendar year, to necessitate only one annual information-gathering effort.

In addition to the general comments above, we offer the following comments on specific disclosure items in the "Development Status" section. Paragraph 1 should be amended to clarify whether an annual or cumulative number of developed residential properties is to be disclosed.

Paragraph 2 should be amended to clarify 1) whether square footage is to be measured in terms of gross, net or taxable square feet, and 2) whether an annual or cumulative number of developed square footage of residential, commercial and industrial properties is to be disclosed.

The disclosure of assessed value required by paragraph 3 appears to be unnecessary. The Mello-Roos district was formed on the basis of appraised value - not assessed value. In fact, assessed value cannot be the basis of the taxing scheme because of rules regarding *ad valorem* property taxes. Furthermore, assessed value is not usually disclosed as part of the Official Statement for the initial offering, so its relevance to secondary market sales is questionable. Determining assessed value on an annual basis (especially once development in the CFD is complete), therefore, seems to be an unwarranted expense, and we believe that paragraph 3 should be deleted.

The disclosure required in paragraph 4 should be clarified regarding 1) whether the number of properties sold is to be determined on an annual or cumulative basis, 2) whether resales are to be counted 3) how value is to be determined, and 4) if value is to be determined based on a revised assessment or whether there is a duty to report the sales price if no revised assessment has occurred. In addition, the treatment of long-term leases should be addressed.

Any value to disclosing vacancy rate information required by paragraph 5 is outweighed by the cost of accumulating such information and the confusion such information may cause. This would especially be the case if the property within the CFD is widely held and if vacancy rates fluctuate a great deal. In addition, if the vacancy rate is to be determined by reference to a particular day, a figure could be misleading, such as when a building is fully leased as of the reporting date, but all leases are due to expire shortly thereafter. On the other hand, more than mere reporting of a fact on a date certain could lead to long and complex determinations on what should be reported and when. In addition, it appears this information would be required for all properties, regardless of whether the special tax is to be paid by a landlord or its tenants. For these reasons, we recommend that paragraph 5 be deleted.

Use of the words "land use classification" in paragraph 6 is ambiguous. This paragraph should be clarified to specifically provide for the disclosure of the percentage of taxable property in the CFD being used for residential, commercial and industrial uses, respectively.

With respect to paragraph 7, we do not understand the purpose of reporting the address of the property owner. Address disclosure suggests that either CDAC or a bondholder has a right to question a property owner, who is simply a taxpayer, not a bond issuer. Since no such right exists, we believe that such disclosure is inappropriate and unnecessary. Finally, see our comment regarding paragraph 3 on the problems with using assessed value to determine the relevant property owners.

With respect to the "Capital Project Status" information, it appears as though this information is limited to the actual infrastructure to be constructed or acquired with Mello-Roos funds. The term "construction accounts" in Item 2 is somewhat unclear, however, and should be clarified to state the "fund balances in Mello-Roos construction accounts" must be reported.

The "Financial Status" disclosure section should expressly state that it applies only to the CFD's financial status, not to the financial status of any developer or taxpayer in the CFD. It should also be clarified to state that only foreclosures resulting from the nonpayment of the special tax need be disclosed. The "debt authorization" levels should be clarified as applying only to the CFD in question. In addition, preparing the requested information on overlapping tax rates will be difficult.

While *ad valorem* taxes and most assessments translate into a rate which is applied, Mello-Roos taxes are a dollar amount. If the Mello-Roos tax is to be translated into a rate, the rate could change annually and/or each time the property is reassessed. Since total tax dollars cannot easily be determined, we recommend that this section be deleted.

RECOMMENDATION #3

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

Consequently, we recommend that the Legislature limit the annual increase in the maximum special tax to two percent (2%) for landowner-approved financings. 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. This limit would apply prospectively to all Mello-Roos bonds issued after the effective date of the authorizing legislation.

Recommendation Comments:

We believe this recommendation appropriately balances the certainty desired by taxpayers with the flexibility needed in determining special tax rates. We therefore have no comments on this proposal at this time.

RECOMMENDATION #4

Require the Issuing Agency to Have a Substantial Interest in the Facilities and Services Funded Through the Special Tax.

Consequently, we recommend that the Legislature require that the local agency forming the CFD be the governmental agency responsible for providing the majority of the facilities and services financed through the CFD. This requirement would apply prospectively to all Mello-Roos bonds issued after the effective date of the authorizing legislation.

Recommendation Comments:

As an initial matter, we note with grave concern the language contained in the introduction to this section which portrays developers as "preying" on agencies. This is an unfair and unnecessary generalization, and we request that it be deleted.

In addition, the recommendation ignores important factors other than the provision of facilities and services which should impact lead agent selection in a Joint Community Facilities Agreement ("JCFA") situation. For example, one jurisdiction may have much more experience with Mello-Roos and/or may have the administrative staff necessary to administer the district, even if it is not responsible for the majority of the infrastructure. Conversely, the jurisdiction responsible for the majority of the infrastructure may be new to Mello-Roos. Such a situation exists in the City and County of Los Angeles, for example, where the County has significant Mello-Roos experience, while the City has never issued Mello-Roos bonds. Alternatively, to the extent two jurisdictions are parties to a JCFA and one jurisdiction is somewhat controlled by the other jurisdiction, (such as a County Park District and a County), the controlling jurisdiction may have public policy reasons, such as oversight with respect to overlapping taxes, for wanting to be the lead agent.

Application of the proposed recommendation to a Joint Exercise of Powers Agreement ("JPA") situation is even more problematic. It is possible that each party to the JPA may form its own separate CFD, with each of the CFD's contributing funds for JPA use. Additionally, in the JPA situation, the JPA, not any one local agency, is responsible for providing the facilities and services to be financed. The concept behind the recommendation does not work in such an event.

Most important, by depriving local agencies of flexibility, the amendment provides a disincentive for joint action. If local agencies cannot control who forms the district, they may choose not to act jointly. The recommendation could, therefore, encourage the creation of inefficient overlapping districts, with each levying its own tax and issuing its own bonds, instead of advancing the goal of one large, more efficient district. In fact, this requirement might make it more difficult to adopt Planning Guidelines as suggested by CDAC (see "Issue 2" herein).

RECOMMENDATION #5

Require that Substantial Redirection of Funds be Subject to Referendum.

Consequently, we recommend that the governing board of the CFD be required to place before the voters any proposal to reallocate funds between the projects identified in the resolution of intention if (1) the reallocation of funds would result in a deviation of more than 20 percent from the original cost estimate for any project identified in the resolution of intention, and (2) the governing board receives a petition signed by 25 percent or more of the voters in the CFD objecting to the reallocation of funds.

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

Recommendation Comments:

We applaud CDAC's change in position from the first draft of the staff report on this issue, in which a mandatory election was required in all cases where more than 10% of the funds are redirected. This would have caused a significant expense which would have been borne by the jurisdiction and its taxpayers.

The current recommendation remains somewhat troubling, however. It is based on the erroneous assumption that the diversion of funds from one project to another means that the first project may not be built. This does not reflect the realities of modern day development. Almost all the items for which Mello-Roos bond proceeds are used must be built under the development agreement or pursuant to a tract map condition. The developer is then required to provide a completion bond that such infrastructure will be completed before it can begin development. Moving funds among projects is usually due to cash flow management issues or delays in one portion of the project which allow a reallocation of funds to another portion of the project, not to the abandonment of needed infrastructure items.

If the redirection of funds must be limited, two aspects of the revised recommendation warrant further refinement. First, the 20% threshold may not be reasonable when you apply it to particular fact situations. For example, a redirection of 20% of a $1 million dollar line item in a $30 million dollar bond issue is *de minimis* -- yet it would be subject to this provision. A reasonable alternative would be to have the provision apply only when a redirection would cause a deviation of 20% of the total bond proceeds to be used in an alternative manner. Second, we recommend that a hearing rather than an election be held on redirections of funds. The legislative body can determine the appropriateness of redirecting the funds based on the sentiments expressed at a public hearing, which places the relevant information before the decision makers without the costs of an election, which include printing and distributing ballots and writing, printing and distributing election pamphlets. The jurisdiction involved would have to pay these costs (assuming additional tax could not be levied by the existing CFD), which could be considerable.

In addition, it is unclear what election standard should apply. Is 2/3 the applicable standard? Such a result seems unduly harsh, especially in the multi-phase project in which a shift of funds might be essential for completing crucial infrastructure. In addition, the time involved in holding an election could cause undue hardships. For example, assume that because of unusual soils problems, the cost of a park system is increased. In contrast, the CFD's sewer system came in under budget, and 22% of the sewer funds are available for transfer to build the park. This substitution of funds is very reasonable, but could not occur under the recommendations without a lengthy election process (instead of hearing) if requested by the public.

RECOMMENDATION #6

Require that Facilities and Services Funded Through the Special Tax Provide a Direct Benefit to CFD Residents.

Consequently, we recommend that the Legislature amend the Mello-Roos Act to require that CFD residents receive a direct benefit from all facilities and services funded through their special tax payments. "Direct benefit" means that CFD residents must have full use of all facilities and services funded through their tax payments. It does not restrict residents outside the CFD from also receiving benefit from these facilities and services. This requirement would apply prospectively to all Mello-Roos bond issues occurring after the effective date of the authorizing legislation.

As mentioned earlier under Recommendation #1, should the Legislature choose not to implement the direct benefit requirement, we recommend that the Notice of Special Tax disclose that the buyer's special tax payments may be used to construct facilities which the buyer may not be permitted to utilize.

Recommendation Comments:

As a number of us expressed at the Meeting, this recommendation causes considerable concern for future use of Mello-Roos by school districts. We also question whether CDAC wants to characterize the school assignment situation in Tracy as "abuse" without interviewing Tracy school officials to explain how its school assignment decisions were reached. As the representative of the Modesto School District testified at the Meeting, school boundary decisions are complex matters. It would not be possible to guarantee specific school assignments for the term of a Mello-Roos bond issuance, which this recommendation would require. School assignment guarantees could cause serious overcrowding or under-utilization of schools.

CDAC's discussion of "divisive distinctions" in a community might cause the Legislature to miss the true issue here - the legal ability of a school district to make any kind of commitment regarding school assignments for the term of the bonds. If this recommendation, which requires such a commitment, is enacted into law, school districts could be practically barred from using Mello-Roos. Such a bar directly conflicts with the State Legislature's existing determination that Mello-Roos is an appropriate financing vehicle for schools. In fact, the Legislature specifically encouraged the use of Mello-Roos by changing the rules under which state funding could be sought. If enacted, this recommendation undermines the Legislature's existing determinations.

The recommendation's definition of "direct benefit" as "full use of all facilities and services funded through their tax payments" could also be carried to the an unfair extreme. What about special programs needed for handicapped or other special education needs? Does the recommendation mean that such programs could not be funded because certain taxpayers would not have full use of them? What about facilities which are not "used" by property owners *per se* - such as sheriff or fire facilities? Does the recommendation preclude funding these items with Mello-Roos bonds? Finally, use of the words "direct benefit" is itself troublesome, since this is the standard used in assessment act laws, and its use here (with a different meaning) is extremely confusing.

We recommend that CDAC withdraw this recommendation and use its alternative instead - that the Notice of Special Tax include a statement regarding the fact that money may be used to construct facilities that a buyer may not be able to utilize. Alternatively, CDAC might recommend that school districts take the Mello-

Roos tax into account (as one of many factors) when making its annual boundary determinations.

Other Issues For Legislative Consideration

Issue 1
The Subsidization of Developers by Homebuyers in Mello-Roos CFDs.

This discussion turns on the concept of a developer "subsidy." If that characterization of existing Mello-Roos practices is adopted, the conclusions discussed follow. We suggest, however, that the use of capitalized interest, cross-collateralization of property and the taxation of raw land differently from developed property are not developer subsidies for the reasons set forth below.

A. Tax Differentials on Developed and Undeveloped Land

CDAC accepted the statement from Ms. Stalling of Muni Financial Services that the reason that developers preferred Mello-Roos financing to assessment act financing is simply because Mello-Roos shifts the tax burden to the developed land. Actually, developers favor Mello-Roos financing for many reasons other than the one offered by Ms. Stalling, including those discussed below.

Mello-Roos is considered beneficial by developers for the following reasons:

(i) Infrastructure Phasing: Mello-Roos financing provides a source of funds by which new roads and other infrastructure improvements may outpace development. This is contrasted with developer fees, which are constrained by the inherent limitations of a "pay-as-you-go" revenue source.

(ii) General Benefit: The infrastructure a developer must provide to obtain land use approvals for most modern day developments is often regional in nature. The addition or expansion of backbone infrastructure such as freeway on/off ramps, sewage treatment plants and collector roads are often a condition of land use approval. Such infrastructure does not lend itself to assessment act financing because of the special or direct benefit which must be shown to levy an assessment. The flexibility of Mello-Roos law enables more regional infrastructure to be financed.

(iii) Funds for Services: Mello-Roos financing can be used to finance certain needed services, such as police, fire, paramedic, and park and recreation services if such services are incremental to those offered at the time the district was formed. With Mello-Roos, the cost of providing such services will not be a drain on the local agency's general fund, and purchasers can be assured that they will receive the services which are crucial to some purchasers' decisions to buy in a particular locality. Thus, the developer is confident that the purchasers within its development will receive an appropriate level of service.

(iv) Illiquidity of the Financial Markets: In the current lending environment, Mello-Roos financing may often be the only source of financing for much needed public improvements. The financial community is also embracing the public-private partnership concept with respect to financing new development. In fact, some financial institutions require that public financing be used as a condition precedent to its own financing.

(v) Lower Cost of Funds: Mello-Roos bond financings are usually tax-exempt, and tax-exempt financing usually carries a lower interest rate than traditional construction financing. Therefore, the cost of constructing the required infrastructure is lower. Stating the obvious, if the interest rate is lower, the "all-in" cost of constructing the infrastructure is lower. This benefits a landowner, as a Mello-Roos taxpayer and as a developer, as well as subsequent property owners. For subsequent property owners, the benefit is equal to the amount by which the present value of the stream of special tax payments is lower than the present value of the stream of increased mortgage payments a buyer would have to make if the developer passed the cost of the infrastructure through as an increased home price.

(vi) Lower Financing Costs: The Mello-Roos Act permits the infrastructure of an entire development site to be financed under a single financing plan. As a result, the developer, and therefore the purchasers, avoid the expense of implementing a number of financing vehicles. For example, rather than create a special assessment district and a Mello-Roos district (and incurring the costs associated with the formation of two different districts), a single Mello-Roos district can be used.

(vii) Less Costly Housing: Because the cost of the improvements financed by Mello-Roos are not borne by the developer, the development community believes (which belief is supported by the data presented by Dr. Joseph Evans at the Hearing) that home prices are lower. This benefits the developer if the decrease in prices does not reduce its profit margin. Purchasers benefit because less money is needed for the down payment and mortgage installments. In addition, because most tax experts believe that the special tax payment is deductible from gross income for income tax purposes, the purchaser's annual costs are lower than if the property owner paid for such improvements through an assessment. As a result, Mello-Roos financing provides easier access to the home buying market.

(viii) District Boundary Lines: The boundaries of a CFD may be non-contiguous and drawn to exclude certain types of properties (such as residents). This flexibility allows a developer and local agencies to form a district and include only those areas that under the circumstances should be taxed. In addition, if the CFD crosses jurisdictional boundaries, a lead agency may be the CFD administrator, instead of a Joint Powers Authority. The opportunity to use a lead agency rather than form a Joint Powers Authority reduces costs significantly. Although cost reductions benefit the developer, they also benefit the ultimate taxpayer.

As the above list demonstrates, Mello-Roos is important to developers for many significant reasons which also benefit the ultimate users of the developed property. In addition, from a public policy standpoint, having the users of infrastructure (who are residents of the CFD's developed property) pay a higher tax is not unacceptable public policy. The owners of the undeveloped land do not benefit from the infrastructure in the same manner as the residents of the residential property or the owners of the commercial or retail property involved. Undeveloped landowners do not use the parks or bikeways, schools and community facilities. Their use of water, sewer and roads is limited.

In fact, the notion of taxes based on usage is a standard concept of tax equity. Assessment districts are often criticized because two homes of unequal size, but the same frontage, might be assessed the same amount for a sewer or water main, even if their use is significantly different. These critics of assessment districts agree with us that the party which has the greatest likelihood of using more of the infrastructure item should pay more. Mello-Roos allows this to happen. Mello-Roos taxes often vary among types of properties (increasing normally with size of property) on the theory that different types (and sites) of properties enjoy different benefits. This same logic applies when dealing with differences between developed and undeveloped property.

Finally, we support David Taussig's position that different developed and undeveloped land taxes make sense. With respect to developed land, home buyers usually want a limit on tax increases. The way to achieve this as development occurs is to retain the flexibility to increase the undeveloped land tax if absorption is delayed. In addition, when major infrastructure, such as a treatment plant must be "front-loaded" into a development, sometimes it is possible to meet the various credit-worthiness tests for bonds only if developed land pays its full tax early, with undeveloped land paying for later infrastructure items. The necessities of multi-phased development mandate flexibility in developed and undeveloped land taxes. It is, therefore, overly simplistic to compare developed and undeveloped property using a common unit of measurement and then mandate a flat tax.

B. Cross Collateralization of Property in CFDs

CDAC has summarized the tension among a number of public policies with respect to cross collateralization. We concur with the CDAC's conclusion.

C. Capitalized interest.

The characterization of capitalized interest as a "subsidy" to developers is unfair, and the assumption that capitalized interest always costs taxpayers money is flawed. In fact, a refusal to permit capitalized interest probably is more expensive to taxpayers, because the increased risk of a default during project build-out will necessitate higher bond interest rates. In addition, as illustrated below, the developer's use of its conventionally available money to pay Mello-Roos taxes early in a project's life may result in greater bank debt and higher interest rates on the construction money actually used to build homes. All of these costs are eventually passed through to the home buyer, and the price of a home may ultimately be higher due to these costs.

For example, assume Developer A arranged for a CFD to construct $10 million in infrastructure financed by Mello-Roos bonds. Developer A now borrows $1 million from its bank to pay the annual Mello-Roos tax and $5 million to construct the remainder of the infrastructure. The net result of this activity is $15 million (less costs of issuance) in new infrastructure. The yield on the Mello-Roos bonds is slightly higher because the bond structure lacks no capitalized interest, an element favorably received by the capital market. The interest rate Developer A must pay its commercial lender is probably also slightly higher because some of the funds are used to pay taxes, rather than for construction. Carrying costs of any type of financing, of course, get passed on through the home price. In this hypothetical, the homeowner appears to be negatively affected from two directions: higher interest rates on the Mello-Roos bonds (which translate into higher taxes) and the higher cost of the conventional loan being passed through in the home price.

Alternatively, Developer B arranged for the CFD to construct $9 million in infrastructure and reserve $1 million for capitalized interest. Developer B then borrowed the same $6 million from its bank to construct the remaining infrastructure. The net result of this activity is also $15 million in new infrastructure, the same result as Developer A. The yield on the bonds in Developer B's case is slightly lower because the bond market is assured of payment when the land is primarily vacant. This, of course, translates into lower taxes. Conventional loan costs are also slightly lower because the money being borrowed is being converted into infrastructure which increases the value of the underlying security. The amount passed through to the homeowners in increased house price costs is less, and the Mello-Roos tax is less. Overall this seems to be a better result.

In a recent letter to Senator Mello, David Taussig concurred with and amplified this analysis. In that letter, Mr. Taussig wrote:

> "It has been argued that capitalized interest costs homeowners money. However, if capitalized interest results in a safer bond issue, the interest rate on the debt will be less, which will save homeowners money. In most cases, capitalized interest will not cost the homeowners anything. Bond proceeds are usually constrained by either a maximum value-to-lien or a maximum tax

> burden. The public improvements that need to be financed usually exceed the bond proceeds available. Whether the limited amount of bond proceeds available are spent on capitalized interest or on public improvements, total debt proceeds, and therefore, total debt service, is the same and homeowners' tax bills are the same."

We agree with Mr. Taussig's conclusion and urge CDAC to look behind what appears initially to be obvious. We believe that once it does, CDAC will find that bond amounts are constrained for the reasons Mr. Taussig suggests. The conclusion which follows from this analysis that capitalized interest should not be portrayed as a subsidy, but as the bondholder protection it is.

Issue 2

Limiting The Maximum Special Tax Rate

If enacted, the two percent of assessed value limitation suggested by CDAC should only apply to residential properties. Raw land often has a very low assessed value if the developer has held it for some time, yet its appraised value may be quite high. Thus, limiting the tax in this manner would be unproductive. Such a limit also undermines the concept that undeveloped land should bear the burden if absorption is less than anticipated. In addition, if the Legislature adopts a per acre tax equity concept, the raw land would significantly reduce the amount that could be levied and, consequently, the amount of infrastructure which could be constructed. With respect to commercial property, the tax is just part of the rent and the market will adjust its lease or rental rates accordingly. Thus, the two percent limitation is unnecessary in the commercial content.

We also recommend for style reasons that the language in the third paragraph of this section regarding the ability of developers to "unload" their property be reworded to state "if developers are unable to sell these properties" . . . .

Finally, CDAC staff is correct that a tax rate limitation may have some undesirable consequences. We question CDAC's fear of "squandering" dollars on lower priority facilities, however. The question of priority is relative, and the priority among the relevant jurisdictions or agencies may vary. Moreover, as discussed above in conjunction with Recommendation #5, developers will have to build needed infrastructure pursuant to tract map conditions or a development agreement. Thus, the feared outcome - "leaving the developing area without the resources to address immediate needs" - is highly unlikely.

We agree with the concept that the various local jurisdictions should adopt Planning Guidelines as a policy matter, but we question the consequences of statutorily mandated guidelines. In urban areas, the Guidelines process could be lengthy, and the primary victim could be the developer. If legislation is enacted that requires that such Guidelines be adopted prior to the issuance of Mello-Roos bonds, a developer could be held hostage by an uncooperative agency that wishes to trade-off its agreement to the Planning Guidelines for additional infrastructure. Such an example is not far-fetched. In these days of worsening fiscal crisis for many governmental agencies, additional burdens, some not directly related to the development's impact, are being shouldered by the developers "voluntarily" in order to achieve consensus on a design or project schedule. Even if the various agencies are cooperative, the mere time involved in reaching such a difficult consensus could significantly increase the cost of development.

Issue 3

The need for Uniform and Independent Land Appraisals

We have no comments on CDAC's discussion of appraisal issues.

In conclusion, we wish to thank you for your consideration of our comments. Please feel free to call upon either of us if we can provide any further information.

Very truly yours,

Ursula H. Hyman

Ursula H. Hyman
of LATHAM & WATKINS

Patricia T Sinclair

Patricia T. Sinclair
of LATHAM & WATKINS

ALLIANCE *for Locally Funded School Facilities*

March 5, 1992

Steve Juarez, Executive Director
California Debt Advisory Commission
915 Capitol Mall, Room 400
Sacramento, CA 94209-001

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CALIFORNIA DEBT
ADVISORY COMMISSION

Dear Mr. Juarez:

The Alliance for Locally Funded School Facilities is a coalition of school districts which rely in whole or in part on non-state funds for providing school facilities in our growing districts. In addition to supplying our members with information and assistance with local funding options, the Alliance also actively seeks to protect and enhance these options and the ability of school districts to avoid or minimize seeking funding from the State. We are therefore very concerned about any potential legislative changes which would jeopardize local funding opportunities for school construction.

Mello-Roos is a viable funding tool for the many diverse local entities chiefly because of its flexibility. It can be customized to fit almost any situation and address any need. Individual communities are different. What is right in one is absolutely wrong in another. The beauty of Mello-Roos has been its flexibility to address California's diversity. No two member school districts from the Alliance who have employed Mello Roos financing started with the same set of circumstances nor developed identical responses. This is not to say changes are not needed. But because of its very complex nature, no quick fix solutions based on surface issues will be appropriate.

Nonetheless, as school districts focused on local sources of financing to build schools, the members of the Alliance recognize that the Mello Roos instrument must be used responsibly in order to remain a viable option for financing the construction of public schools. Debt instruments predicated on Mello Roos taxes will receive their best possible acceptance in the marketplace only if the Mello Roos financing mechanism can be properly defined and articulated to protect the greatest array of interests; taxpayers, developers and school districts. Toward that mutually desirable end, the Alliance is pleased to generally support the effort to clarify practices surrounding Mello Roos taxation and financing, and to offer the following comments regarding CDAC's recommendations for possible legislative changes to the Mello Roos law itself.

DISCLOSURE

The Alliance is supportive of improved disclosure requirements, both for the initial sale and the resale market. In fact, improvement is absolutely needed and this proposal may not go far enough. The public agency now has no control over the disclosure process since it is a developer responsibility. Disclosure should be required <u>before</u> a prospective buyer can even start the bidding process. Every sales office should be required to have a prominently posted sign identifying the special tax and advising prospective purchasers to ask for details. The public agency should have approval authority over the disclosure statement and strengthen it if necessary. Specifying the exact contents in statute may actually lessen disclosure in some circumstances by making it difficult to include important information regarding a particular district. Therefore, we believe the statutory requirement should be a minimum disclosure to which the public agency can add additional information.

Secondary market disclosure is also an important issue, although the practical aspects of how it would function are not clear from the report. The existing tax bill on a resale house should give a clear indication of what taxes exist on the property. Any disclosure in the secondary market should be tied to the title report, and should not be the responsibility of school districts.

ANNUAL REPORT

The Alliance generally supports the annual compilation and reporting of information relative to the special tax and the debt it supports. However, a distinction needs to be made between information that a school district can readily provide and that which should be more appropriately researched by the investment banking community in order to service the secondary market.

Annual reporting and compilation of information is an excellent proposal, as long as the requirements for the report are reasonable. Currently, an annual tax report is prepared as of March 1 to determine the appropriate tax levies. Annual audits are also prepared, as of June 30. If a calendar year reporting schedule is established, it should be based on information collected as of the March and June dates.

What we report is also a concern. Some of the information suggested in the staff report would be very costly and time-consuming to compile and would provide minimal value to an investor seeking information about the District. Number and value of sales and commercial/industrial vacancy rates may be very difficult to establish in a large district on an annual basis. In addition, a CFD may not be notified of bankruptcies of property owners within the district, making this reporting requirement impossible. The value of the information on an annual basis over the 30 to 40 year life of a CFD needs to be weighed against the cost of preparing the information. Requiring some of this information as part of the Official Statement disclosures for a bond sale may be more appropriate.

2% INCREASE IN SPECIAL TAX

The Alliance is supportive of the proposed limitation of an annual two percent maximum tax escalator for landowner-approved CFD's, along with the proposed exception accommodating the provision of services based upon a measure of inflation. However, this limitation should only apply to residential developments. It is also particularly important to acknowledge that the proposed restrictions apply prospectively only. There is a definite risk of rendering existing CFD's powerless to meet the needs for which they were established by changing the rules late in the game.

The Alliance also supports the premise that registered voter-approved CFD's should be governed by the political marketplace, and that no limitations should be placed on the escalation of the annual maximum tax in such entities.

SUBSTANTIAL INTEREST IN FACILITIES

The Alliance has severe reservations about the long term desirability of resorting to sweeping generalizations when approaching this issue. While the alleged practice of "Mello-Roos shopping" should be prohibited, there are often solid public policy reasons for the lead agency in a Mello-Roos consortium to be other than the agency with the most substantial interest. To create the broad prohibition proposed by the CDAC is absolutely contrary to the concept of coordinated local planning and efficient financing of public facilities. It may also be asking for trouble in a way that might not be obvious on the surface. An example is an existing CFD in Stanislaus County which is providing facilities for the Sanitary, Fire, Elementary and High School districts as well as the county. The most money (35.7%) goes to the Sanitary District - an agency with no staff other than the treatment plant operator. The next greatest use is the elementary district (33.1%) - a 1500 student district whose staff is barely keeping one step ahead of housing kids and with little experience in the field of public finance. The next greatest user of funds is the county. While the county is a large agency with a large staff and they've handled a number of financial transactions, they've also been in trouble with the grand jury, the FPPC and many others related to the execution and fiscal soundness of those transactions. The next greatest user of the funds - with only 9.6% - is the High School District, a 28,000+ school district with staff specializing and experienced in the field of capital finance. Who would you rather have administer a $42M bond program? This transaction was handled through a JPA but might have been done more efficiently through a joint financing agreement with a single agency acting as lead.

What was done in this case - despite the headaches involved in coordinating among several agencies - is what should always be done. To bring all the agencies together in a forum in which no agency gets anything unless they can all reach agreement to meet all needs in the best interest of the community.

REDIRECTION OF FUNDS

The Alliance is supportive of the proposed addition of a referendum requirement based on a 20 percent criteria of redirection of bond proceeds coupled with a 25 percent of registered CFD voter criteria for the validity of a petition. However exceptions need to be made to allow the continuation of programs which may not have been implemented but for which obligations have been made. It does not serve wider public policy to create an opportunity for voters to eliminate a program which may have been a mitigation requirement under CEQA or as part of the project approval process, simply because costs have escalated due to inflation or new requirements (such as increased school construction safety standard under the Field Act). If a high priority, authorized facility ends up costing more than anticipated, voters should not be given the option to negate provision of that facility. Since facilities not included in the original Resolution of Formation cannot be funded through a redirection of funds by the local agency, taxpayers should still get the facilities they expected, unless the total program costs more than originally anticipated. In this case, the local agency is in the best position to decide which projects are of highest priority.

DIRECT BENEFIT

The Alliance cannot support the strict adherence to the concept of "direct benefit" when it is applied to CFD's established by school districts. No matter how politically or emotionally attractive the concept might appear, it has the potential of eliminating Mello-Roos as a financing mechanism for building schools. In simple terms, it doesn't work. For example, direct benefit would be an infeasible concept in the following situations:

- when a CFD consists of a number of different development projects scattered throughout a school district but all contributing to a single new school;
- when facilities, such as a junior or senior high school, are regionalized in nature;
- when desegregation plans which have been mandated or adopted voluntarily require attendance boundaries other than CFD boundaries;
- when establishing coterminous CFD/attendance boundaries would result in de facto segregation;
- when the CFD school is completely filled with CFD students and more CFD students continue to enroll.

Furthermore, how can the concept of direct benefit be applied to the homeowner/taxpayer who has no children to send to school? Is such an individual to be exempted from the special tax?

In a registered voter-approved CFD any questions of benefit are resolved at the ballot box. Landowners-approved CFD's require a different approach, and the Alliance has one to offer.

The Alliance believes that the provision of school facilities is a general societal benefit which supports the property values of all the property owners of the community, whether they have children to send to school or not. Nonetheless, having advanced such a position there is question of establishing the greater benefit received by a property in the CFD as opposed to one which does not pay the special tax. The Alliance believes the resolution of this inherent dilemma is contained in the Mello-Roos law itself. The law allows for the capping of previously established bonded indebtedness in the process of CFD formation. If such a provision were required in landowner-approved CFD's, the obligations for "old" debt on the land would be capped at the relatively low raw land value prior to the creation of any "new" special tax. In such a fashion, the societal benefit for the addition of new school facilities to serve the community would be more directly credited to properties within the CFD, while at the same time relieving them from the obligation to share in quite as large a portion of the previously existing debt attributable to the rest of the community.

If some resolution such as the one offered above cannot be found, then the most the Alliance can support is the proper disclosure of the purported lack of direct benefit at the time the property is sold.

Thank you for the opportunity to provide input to the Commission's report on proposed legislative changes to the Mello-Roos Act. If you have any questions about the Alliance or our positions, please call our legislative advocates at (916) 447-8420.

Sincerely,

Paul Reed

Paul Reed, President
Irvine Unified School District

Ron Feist, Vice-President
Eureka Elementary School District

Alliance Board of Directors

Debbe Bailey,
Modesto City Schools

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March 9, 1992

Kathleen Brown
California State Treasurer
Chair, California Debt Advisory Commission
915 Capital Mall, Room 400
Sacramento, CA 94209-0001

Dear Treasurer Brown:

Attached are the comments of the Building Industry Association of Orange County to the "Report on Proposed Legislative Changes to the Mello-Roos Act" prepared for the California Debt Advisory Commission.

BIA/Orange County represents 950 local member companies involved in residential and commercial development activities.

These comments were compiled with the assistance of John Yeager, Esq. (Pettis, Tester, Kruse & Krinsky), Keenan Rice (David Taussig and Associates), and Tom Daly (BIA/OC Director of Government Affairs).

Sincerely,

Dave Colgan j.w.

Dave Colgan, Esq.
McKittrick, Jackson, DeMarco & Peckenpaugh
Chairman, Ad Hoc Committee on Mello-Roos

DC/jw

Attachment: Response to the Report

cc: BIA/OC Executive Committee
Christine Diemer, Executive Director

RESPONSE TO THE CALIFORNIA DEBT ADVISORY COMMISSION REPORT ON PROPOSED LEGISLATIVE CHANGES TO THE MELLO-ROOS ACT

These comments are made by the Building Industry Association, Orange County Region ("BIAOC") in response to the California Debt Advisory Commission (CDAC) "Report on Proposed Legislative Changes to the Mello-Roos Act" (the "CDAC Report"). The comments have been prepared by a special BIAOC committee of Mello-Roos experts that was established in December 1991 and given the task of recommending reforms to the Mello-Roos Act. We appreciate CDAC's efforts to solicit comments from the building industry, and we look forward to working with you and the State Legislature to strengthen and improve the Mello-Roos Act.

A combination of circumstances make the Mello-Roos Act indispensable to the provision of housing in the State. These circumstances include the local funding constraints created by Proposition 13, increased state mandates in the areas of planning and environmental protection and increased local demands for the concurrent provision of public infrastructure and housing.

Legislative changes to the Mello-Roos Act, if not carefully considered, may be detrimental to efforts to provide housing in California at a time when, as explained by Ward Connerly, a gubernatorial appointee to the California Housing Partnership Corporation, "our housing delivery system is in its most chaotic state ever" (*Land Use Forum*, Fall 1991, 6). Changes in the Mello-Roos Act, if they do have a detrimental impact on housing, will most hurt middle-to-low income households. The damage, however, is not restricted there; as the high cost of housing affects the business and industries in California, all of the people of the State are affected. As again explained by Ward Connerly:

> There is hardly a major employer in the State that does not worry about the effect of the housing crises on its ability to attract and retain a labor force. Lower-income housing advocates, public policy makers, and the building industry have for years delivered the message that California has serious housing problems, but the message merely had social or self-interest implications until the business sector of our State, led by the Chamber of Commerce, made housing a prominent public policy concern. The business community's interest in housing has made it all too clear that the economic future of California is directly linked to the solutions we find to our housing problems. (ibid., 6-7)

We urge CDAC to consider the effect of its recommendations on housing and the California economy, in general. We submit the following comments as concerns we have regarding the impact of CDAC's recommendations.

RESPONSE TO RECOMMENDATION #1 -- Disclosure to Buyers

The building industry agrees that improving the dissemination of information regarding a CFD to homebuyers within the CFD is essential. In order to be effective, disclosure must be simple and accurate and the disclosure program should be workable. The BIAOC Mello-Roos committee is currently developing a model "Notice of Special Tax", a draft copy of which is attached hereto, which is intended to provide a uniform, simple and clear description to homebuyers of the CFD special taxes, CFD facilities, and authorized and outstanding bonded indebtedness. Please note that the model form has not been finalized by the committee nor approved by the BIAOC Board. The committee is also seeking to develop a simple method for recording information annually with respect to a CFD that would serve to enhance disclosure on the resale market. The recorded information could include a description of outstanding bonded indebtedness and the actual special tax levied for the previous year.

We support CDAC's recommendation to amend the Notice of Special Tax requirement to advance the disclosure requirement to the time that the buyer signs a purchase contract. We recommend adding a requirement that a copy of the signed notice be forwarded to the issuing agency.

We substantially concur with CDAC's recommendations with respect to the type of information which should be included in the Notice of Special Tax with two exceptions. First, including cost estimates for each facility and service authorized to be financed through the CFD will only lead to confusion, not clarification. In many cases, such cost estimates may be preliminary in nature and subject to substantial modification if the facilities are to be constructed over a long period of time in order to accommodate and be coordinated with the build out of a large planned community. Second, we believe that including in a standardized disclosure form language advising a potential homebuyer to "consider the higher annual tax payments associated with the property when formulating her bid price" ignores market economics and the unique circumstances inherent in each CFD. For example, in many situations, it would be appropriate to advise the potential homebuyer that without the CFD, she would be paying more for her home. Moreover, although the sellers of real property are obligated to disclose to a potential buyer various items that may impact the buyer's decision, we are not aware of any existing statutes or cases that would require the seller to advise the same buyer that she should take into account the matter disclosed in formulating her bid price.

RESPONSE TO RECOMMENDATION #2 -- Annual Reporting

We agree that increased reporting on Mello-Roos bonds would be beneficial in enhancing the credit quality of the bonds. Because annual reporting may have various costs and risks, however, it should not be mandated. Rather, the decision to provide for annual reporting should be left to the discretion of the issuer who may be best able to weigh the costs and benefits. For example, while CDAC has attempted to eliminate the potential liability its requirements could have for local agencies, we are not convinced that all liability has been eliminated. State law, for example, cannot protect the issuer from liability under federal law or the laws of other states in which the CFD bonds are sold. The liability implications of mandated reporting requirements should be very carefully considered. In addition, compiling information, such as vacancy rates, that is not public information may prove to be both time consuming and costly.

If CDAC is correct that improving the flow of information will result in lower bond yields, then it appears that the market itself will provide adequate incentive for issuers to accept covenants to provide annual or periodic reports of specific information. Mandating annual reporting, therefore, would appear to be unnecessary and should be left to the discretion of the local agencies.

RESPONSE TO RECOMMENDATION #3 -- Annual Special Tax Increase

CDAC has proposed to limit the annual increase in the maximum special tax to 2% for landowner-approved financings. Changes in the Mello-Roos Act should address areas that have proven to be problematic in practice. The CDAC Report clearly states that there does not appear to be a problem with annual special tax increases. Local agencies have shown their ability to be self-regulating in this area. Consequently, we question the need for State legislation.

If CDAC still perceives the need to make a recommendation to restrict annual tax increases, however, we suggest the limitation only apply to residential property after occupancy. CFD's are often formed to provide facilities that are needed as communities build out. Some of these facilities may be for future residents and will not be needed for many years. The cost of the facilities may increase by more than two percent per year. Limiting special tax increases to only two percent per year before homes are actually built and before the facilities are actually needed will cause the first residents in a community to subsidize future residents and will impede the ability of the CFD to finance all of the required facilities.

RESPONSE TO RECOMMENDATION #4 -- Substantial Interest In Facilities By Issuing Agency

CDAC has recommended that "the local agency forming the CFD be the governmental agency responsible for providing the majority of the facilities and services financed through the CFD." Like CDAC Recommendation #3, this is another recommendation that does not appear to be necessary to address an existing problem or past abuses. CDAC's speculation that requiring the issuing agency to be responsible for providing a majority of the facilities and service financed through the CFD will prevent landowners from "preying on less sophisticated agencies" is unsupported by any evidence before the CDAC and is unfair to both the development industry and to the State's local governments. Such a requirement is unnecessary and unworkable. The Mello-Roos Act was amended last year to require that joint financing agreements be executed prior to adoption of the resolution of formation establishing a CFD by all agencies which will own facilities to be financed through the CFD. This brings every agency with an interest in the CFD into the process early on and requires each agency's consent before the CFD can be formed.

RESPONSE TO RECOMMENDATION #5 -- Redirection of Funds

CDAC Recommendation #5 does not address the essence of the homebuyers' concerns expressed in the CDAC hearing, which were with the type of facilities financed through the CFD, not the reallocation of bond proceeds. The only way to eliminate the homebuyers' concern, however, is to eliminate the landowner vote provisions of the Mello-Roos Act. The landowner vote provisions are essential to a local agency's ability to provide necessary infrastructure concurrent with new development. Not every homebuyer within a CFD will agree with every facility that is deemed necessary for a development, but that is not a reason to amend the Mello-Roos Act in a manner that will render it useless.

Requiring registered voters within a CFD to approve facilities cost increases imposes an unnecessary burden on issuing agencies without providing a realistic solution. As stated in the CDAC Report, the real problem is disclosure and improving disclosure is the solution. The facilities anticipated to be funded through the CFD should be clearly described in the Notice of Special Tax. A statement could be added to the Notice, similar to that proposed in SB 1464, disclosing that some or all of the facilities have not been constructed or acquired and it is possible that some may never be constructed or acquired.

Redirection of funds is already restricted by existing law. The improvements to be financed by a Mello-Roos district must be disclosed in the petition, the resolution of intention, the resolution of formation, the engineer's report and the disclosure to prospective buyers. Improvements not disclosed in these documents cannot be paid for with Mello-Roos funds without approval of the registered voters in the district.

As previously explained, Mello-Roos districts are important to planning efforts by local agencies. Mello-Roos districts are formed to provide facilities that may not be needed for many years. It is not always possible to predict what the cost of these facilities will be for many years in the future. CDAC's recommendation does not prevent redirection of funds. Existing law already prevents redirection of funds. CDAC's recommendation would only have the effect of penalizing local agencies for coordinating long term development plans with the provision of infrastructure over the long term. The recommendation would also penalize their inability to predict rates of inflation many years into the future.

RESPONSE TO RECOMMENDATION #6 -- Direct Benefit to CFD Residents

CDAC has recommended that "CFD residents receive a direct benefit from all facilities and services funded through their special tax payments." CDAC defines "direct benefit" to mean that "CFD residents must have full use of all facilities and services funded through their tax payments."

One of the reasons that the Mello-Roos Act is so beneficial to local governments is that it permits financing of facilities that cannot be financed through traditional special assessment districts. There are two important differences in assessment districts and Mello-Roos districts, which explain why Mello-Roos has become such an important public financing mechanism in the last decade. First, assessment districts can only finance improvements that have a specific benefit. Before Proposition 13, local agencies could afford to pay for general benefit improvements. Local agencies are no longer able to pay for these improvements, and a financing mechanism such as Mello-Roos, which is able to pay for general benefit improvements, has become necessary. Second, assessment district apportionment methodology is inflexible and is cumbersome to use in the planned areas -- which usually have many phases that build-out over many years -- that are required by current planning laws. Mello-Roos has the flexibility required to provide infrastructure, on a timely basis, to these planned areas.

We perceive that one of the problems with a "direct benefit" requirement is the various interpretations of CDAC's recommended definition of direct benefit. Does "full use" mean that the property owners within the CFD are the sole users of the facility? If so, CFDs would no longer be available to finance the completion of regional capital improvements such as major circulation, water and sewer facilities. Such an interpretation would impose a benefit test more strict than the special and direct benefit test used for assessment districts. We do not think that is CDAC's intent. It appears that CDAC's intent is instead to ensure that CFD taxpayers can use facilities financed through CFD special taxes. This concern should be addressed through the statutes and regulations governing the particular service provider and not through the Mello-Roos Act.

ADDITIONAL ISSUES

In the interest of time, we will not address some of the additional issues identified in the CDAC Report for which recommendations were not prepared. To the extent that those issues are not addressed by other commentors, we will address them in subsequent communications with the CDAC or the Legislature. We would obviously take exception to some of the statements with respect to the perceived subsidization of developers by homebuyers in CFDs. Many of the attributes of the Mello-Roos Act and common practices in structuring CFDs which are purported to provide the so-called "subsidy", in fact, enhance the credit quality of the Mello-Roos bonds. The CDAC Report acknowledges, for example, that "capitalized interest clearly can improve the credit quality of bonds." Given CDAC's stated concern with credit quality, any recommendations that are made to reduce the "subsidy" should be carefully evaluated against their credit quality impact.

Limiting the maximum special tax rate or allocating taxing capacity to many various local agencies would appear to be unnecessary because there have been few if any abuses that would require such limitations. On the issue of uniform appraisal standards, we agree that uniformity in the appraisal methods utilized in connection with Mello-Roos bond issues is a worthy objective and would be welcomed.

DRAFT

NOTICE OF SPECIAL TAX

MELLO-ROOS FINANCING INFORMATION

The following information is being provided to all prospective buyers in the [name of project] project to inform you that the property you intend to purchase is located in a Mello-Roos Community Facilities District, created by the [name of entity forming CFD]. This means that a Mello-Roos Special Tax lien has been placed on this property, and that as a homebuyer in this development, you will be responsible for paying Special Taxes which are in addition to the standard property taxes paid by homeowners in other parts of [insert name of city or county]. Information summarizing the specific tax liabilities associated with this Community Facilities District, plus facilities to be financed, is presented in this brochure. A copy of this document with your signature will be kept on file with the [name of entity forming CFD].

BACKGROUND

A Community Facilities District (CFD No. ___) has been established in the [insert name of project] project pursuant to the Mello-Roos Community Facilities Act of 1982. This Act was passed by the California Legislature in response to public funding limitations imposed by Proposition 13, in order to provide an alternative method to finance the construction of public facilities serving [insert name of project] in a timely

A CFD may issue and sell bonds to provide funds to acquire or construct public capital facilities. These bonds qualify for tax exempt status, thereby providing a lower interest rate than conventional, taxable financing methods.

FINANCING AND FACILITIES

CFD No. ___ is authorized to issue up to $______ in bonds. [In ______________, CFD No. ___ issued $_________ in bonds. The bonds have a ___-year term. These bonds are secured by all property within CFD No. ____ and will be repaid by a levy of a Special Tax on this property. Therefore, the levy of Special Tax to pay all indebtedness in connection with such bond issuance is projected to terminate as of the ____ - ____ tax year.] [It is anticipated that CFD No. ___ will issue [additional] bonds in the near future.] The issuance of [additional] bonds could result in the levy of a Special Tax [beyond the ___ - ___ tax year] [For the term of the bonds or until the facilities are completed, whichever occurs last.] [The term of the bonds cannot exceed 40 years.] This Special Tax will be levied beginning in the ____ - ____ tax year and will be collected semi-annually at the same time and in the same manner as regular property taxes. The facilities that will be financed by the levy of this Special Tax are listed below in Table 1.

TABLE 1

[Insert description of all facilities.]

MELLO-ROOS SPECIAL TAXES

As mentioned above, CFD No. ____ [will issue] [has issued] tax exempt bonds to be repaid by the levy of a Special Tax on each [residential unit, commercial property, other classification] within the CFD. Table 2 outlines the maximum ____ - ____ Mello-Roos Special Tax to be paid by each category of land use. [The Special Tax for each class of property listed below is subject to an annual increase of two percent.] These Special Taxes would be paid in addition to the standard level of property taxes paid by property owners within the [insert name of city or county].

TABLE 2

[Insert tax rates including description of alternative tax rate, if any.]

[Describe prepayment option, if available.]

ACKNOWLEDGEMENT

I, the undersigned, acknowledge that I have read this disclosure and understand that a Special Tax will be collected along with regular property taxes to finance public facilities as listed in Table 1. By reference to Table 2 of this disclosure, I recognize that the property I am considering for purchase falls into Class ___, and I understand that I may be responsible for the corresponding maximum Mello-Roos Special Tax. I also understand that a copy of this disclosure with my signature will be kept on file with the [name of city or county forming CFD.]

I ☐ have ☐ have not executed an agreement to purchase.
(initial one)

Signed: ______________________

Dated: ______________________

Signed: ______________________

Dated: ______________________

NOTE: IF YOU HAVE EXECUTED A PURCHASE AGREEMENT BEFORE RECEIVING THIS DISCLOSURE, YOU SHALL HAVE THREE (3) DAYS AFTER DELIVERY OF THIS DISCLOSURE IN PERSON OR FIVE (5) DAYS AFTER DELIVERY BY DEPOSIT IN THE U.S. MAIL TO TERMINATE THE PURCHASE AGREEMENT BY DELIVERY OF WRITTEN NOTICE OF THAT TERMINATION TO THE SELLER.

This brochure is only intended to provide a summary of the information contained in the "Notice of Special Tax Lien" from the title report for your property. For more detailed information, a prospective homeowner should review the entire "Notice of Special Tax Lien," which can be obtained from the [insert name of entity forming CFD].

JACK C. CROSE
ATTORNEY
INCORPORATED

STATE TREASURER'S
EXECUTIVE OFFICE
92 MAR -5 PM 2:34

March 6, 1992

Steve J

The Honorable Kathleen Brown
State Treasurer
915 Capitol Mall, Room 110
Sacramento, CA 95814

Dear Treasurer Brown:

The purpose of this letter is to respond as lobbyist for the California Public Securities Association to your request for comments on the CDAC report on proposed legislative changes to the Mello-Roos Act.

My comments reflect the perspective of CPSAs Directors and members whose function is to underwrite state and local tax exempt bonds and, therefore, have concerns for the quality of bonds we sell to our customers and the maintenance of the security of outstanding bonds. Directors discussed the CDAC report in detail at a special meeting last week and offer the following comments.

In response to Recommendation No. 1, the securities industry has a long record of support for comprehensive consumer disclosure standards and endorses efforts to improve them.

From the securities industry and investor viewpoint, implementation of Recommendation No. 2 would be helpful. Secondary market liquidity is all important and investors need accurate information which currently is not easily available.

Development status, however, can change overnight and this volatility makes the cost-benefit of an annual report less.

Recommendation No. 3 would appear to prohibit any increase in the specified tax other than the two percent increase. One of the features of most Mello-Roos special taxes is the presence of a "back-up" tax.

This back-up tax allows for a higher levy on a residential parcel if, as the result of changes in development, project density is significantly reduced. In

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other words, the per unit tax is established by assuming a certain number of units will be built and will generate the required taxes. If less units are built, there may not be enough units to generate or produce the required taxes to pay debt service on the bonds.

The back-up tax is generally established on a per acre basis sufficient to produce enough taxes to pay for debt service regardless of whether one unit is built per acre or six units per acre.

If the project ends up with the number of units per acre which were forecast originally, everything works fine. If density is below expectation, the possible back-up, which is disclosed, is needed.

Standard & Poor's has stated in their January 27 report on Features of Investment Grade Mello-Roos Bonds that this coverage feature sets Mello-Roos apart from 1915 Act Bonds and is one of the credit strengths of Mello-Roos. It might also be noted that general obligation bonds have a similar feature, although much more open-ended. In a G.O. situation, if a large part of the tax base does not pay, every other taxpayer's property taxes will be increased to whatever level is required to collect enough taxes to meet debt service. Generally, Mello-Roos taxes provide only about ten percent coverage.

Recommendation No. 4 is a public policy issue which can be resolved by the dominant local agency refusing to take part in a CFD formed by an unqualified agency. This is occurring in many jurisdictions.

Recommendation No. 5 could easily pose a threat to the security of bonds already issued should projects included in the original resolution of intention be materially changed.

Recommendation No. 6 presents a major public policy issue.

Issue No. 3 in the CDAC report discusses value to lien ratios and appraisal standards. While in most cases, the investment community endorses a 3 to 1 ratio, CPSA feels it would be better to require local governments to include value to lien requirements as part of a comprehensive Mello-Roos policy.

CPSA supports the concept of independent appraisals and feels the appraiser should be the agent of the sponsoring public agency. Uniform appraisal standards are highly desirable, and efforts are being made at the federal and state levels to achieve this goal.

The Mello-Roos Act has worked well, generally, in filling part of California's infrastructure needs which developed following the enactment of Proposition 13.

Some glitches have developed as this innovative program has been implemented in the fast growth areas of the state.

CPSAs officers and directors are pleased to participate in the discussions of improvements in this important body of law.

Sincerely,

Jack C. Crose

JCC/jsh

cc: CPSA Board of Directors

SCHOOLS

MODESTO CITY SCHOOLS

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Administrative Offices (209) 576-4011/Fax (209) 576-4184

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CALIFORNIA DEBT ADVISORY COMMISSION

February 11, 1992

Steve Juarez, Executive Director
California Debt Advisory Commission
P.O. Box 942809
Sacramento, CA 94209-0001

Dear Mr. Juarez:

I have read the Commissions' publication "Mello-Roos Financing in California" and find it to be generally well-presented. I have one specific comment on an item which I believe needs to be corrected, either in interpretation or by legislation.

On page 58 under the section titled "Identify Service Standards in the General Plan" a Statement is made that "the operative standards for school facilities should be the cost and area standards promulgated by the State Allocation Board." This Statement appears to be addressed to concerns over the potential "gold plating" of schools if local standards are used. This interpretation presents two problems.

First, the State standards used by the SAB are generally acknowledged to be **minimum** standards and are severely limited in comparison with other States' allowances or recommendations. A local community should be allowed to set standards for what is educationally appropriate rather than what the SAB views as the minimum to be constructed when State funds are requested.

Second, current State law allows local districts to build beyond State standards using local funds, the source of which may well be Mello-Roos. Restricting expenditure of Mello-Roos funds to State standards may result in local districts never having the opportunity to build educationally appropriate facilities, even with the support of the local community.

OUR FOURTH R IS RESPONSIBILITY

I believe the bonding capacity restrictions already inherent in structuring a Mello-Roos financing will naturally act to prohibit "gold plating" of schools. If such a possibility is of concern to the Commission, I would suggest standards should be applied to all local agencies, not just schools. How fancy should parks or city halls be? These are issues which should properly be decided at the local level if local funds are being used.

As you know, I am very interested in the use of Mello-Roos and all other potential funding sources to deal with school facility needs. I hope that the State will not create needless restrictions within the already limited options available to school districts to provide adequate educational facilities and opportunities to the children of this State.

Please call me if you have questions or need further information about my concerns.

Sincerely,

MODESTO CITY SCHOOLS

Deborah S. Bailey, Director
Planning and Research

James C. Enochs
Superintendent
Sandra L. Lemmons
Deputy Superintendent
Business Services
David C. Mello
Assistant Superintendent
Personnel Services
Sharon L. Rohrke
Assistant Superintendent
Administrative & Pupil Services
Delbert R. Rydquist
Assistant Superintendent
Educational Services

MODESTO CITY SCHOOLS

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FAX

March 6, 1992

Steve Juarez
California Debt Advisory Commission
P.O. Box 942809
Sacramento, CA 94209-0001

Dear Mr. Juarez:

Modesto City Schools is a large (28,000+ students) K-12 school district which has been experiencing approximately 5% growth. Our Long-Range Facility Master Plan calls for use of Mello-Roos financing as our primary source of funds for building future schools. We expect to need to construct at least two elementary schools and a new high school over the next five years as well as needing major expansion at several existing sites. We have already placed nearly 60% of our elementary students on year-round schedules and expect to have approximately 75% of our K-6 students on year-round within two to three years. We are greatly concerned about possible changes to the Mello-Roos Community Facilities Act which might limit our ability to fund future schools.

The issues raised in the Commission's staff proposal really come down to the basic question of how we will pay for the impacts of growth. Given the tremendous demand for new school facilities which California will be facing over the next decade, the last thing we need to do is limit our options.

There are three basic ways to pay for the impacts of growth: general obligation bonds, fees or special taxes.

When an existing community is experiencing the impacts of growth, asking them to pay higher taxes so more people can move in to cause more traffic congestion, air pollution, etc. is highly unlikely to succeed. What's more, is it fair to ask those who have paid to develop a community's infrastructure over time to share in the additional costs of improvements not needed if new houses aren't built? The average voter usually isn't aware of the economic benefits associated with new development. While general obligation bonds should not be written off, they cannot be relied on given current approval rates. In addition, what does a community which has already approved general tax increases turn to when new growth impacts must be mitigated? The Modesto community approved $109M in school bonds in 1987 to deal with existing needs with the expectation that new growth would pay its own way.

Developer fees can be used to pay for mitigating impacts of new development. But if fees are used alone, $30,000-40,000 will be added to the price of a new home, resulting in not only a higher purchase price, but higher interest payments over the life of the mortgage. The bigger up-front cost also prices many developers out of the California market and over time will, based on simple laws of supply and demand, drive up the cost of housing by even more than the amount of the fees. Fees have their place, but they may not be a feasible way to do it all.

This brings us to special taxes, such as Mello-Roos, which is quite possibly the most economical way to fund growth in infrastructure needs. We don't want to do anything to jeopardize its use or we have two alternatives: insufficient infrastructure or less available/affordable housing.

While Modesto City Schools supports most of the changes proposed by CDAC staff, we are particularly concerned about two of the proposals:

1. substantial interest
2. direct benefit

SUBSTANTIAL INTEREST

Modesto City Schools strongly believes in comprehensive community planning. All agencies need to work together to best meet the community's needs and the local agencies should have all tools available to accomplish this goal. Restrictions such as the "substantial interest" proposal may actually create more costs and potential implementation problems. We are especially concerned that even school projects jointly financed between non-unified districts would be restricted. In the Modesto area we are currently working on a proposal to implement a comprehensive "schools Mega-Mello" which could be accessed by any development project any where within the Modesto High School District and eight feeder elementary districts.

This would provide the most cost-effective financing, provide comparable costs and mechanisms throughout the area and simplify the process for everyone involved. As the largest and most experienced entity, Modesto City Schools will probably be the "lead" agency but would not receive more than 50% of the benefit. We do not think it would be in the best public interest to instead require each elementary district and the high school district to implement separate Community Facilities Districts (CFDs).

In addition, the City of Modesto has developed an 1800-acre specific plan project which includes a comprehensive financing plan. It only makes sense to pay for all the infrastructure, including schools, through a comprehensive plan. If the final decision by the local agencies to have schools, sewers, roads, etc., all included in a single bond package, the administering agency should be the one deemed most appropriate at the local level.

DIRECT BENEFIT

Although this is an issue with a lot of surface emotional appeal, the direct benefit requirement would be absolutely unworkable in a number of situations related to schools. How long would the locally elected officials' hands be tied in providing the best educational program in their district? I could support a mandatory consideration by a school board of the interaction between attendance boundaries and CFD boundaries. Any absolute restriction of this nature could preclude Mello-Roos financing for schools. The last thing California needs is to reduce the options for funding school facilities.

MULTI-PHASE PROJECTS

Modesto City Schools would also like to comment on one of the "other issues" identified in the staff report but not placed in the form of recommendations. The draft report appears to be concerned that a long-term multi-phase approach to CFD financing is inappropriate and that later debt should be subject to a registered voter vote. How, then, does a local planning agency ensure that all impacts will be mitigated as required by CEQA or the general plan when a long-term project is approved? An agency could not agree to a mitigation measure that consists of an assumed voter bond approval some time in the future.

An additional issue was approached in the original draft report but was not included in any recommendation. Consideration needs to be given to how all local agencies can be assured of equal access to the available tax base.

To protect agencies which do not have land use development approval rights, consideration should be given to adopting a mandatory consultation process similar to the fiscal review requirement in redevelopment any time any agency proposes to implement a Mello-Roos district. Something akin to the fiscal review process would force a public prioritization of infrastructure needs. An additional requirement to mandate that the forming agency allow participation in the financing plan by any agency that can demonstrate need and by not allowing finalization of the CFD until agreement has been reached would ensure that those agencies that do not hold development approval authority - such as water, fire, sewer and school districts - would be guaranteed access to this funding mechanism and ensure that none are shut out of the loop while the available tax base is used up.

As stated earlier, Modesto City Schools is very concerned that Mello-Roos remain a viable option for school construction. We've already done all we can through developer fees and general obligation bonds. Given that the State program is likely to become a program of last resort, we feel it is imperative that all existing financing tools be maximized. Our taxpayers should not be forced to again experience overcrowded schools because the new growth can no longer be required to mitigate its impacts due to changes in the Mello-Roos law.

Sincerely,

MODESTO CITY SCHOOLS

Deborah S Bailey

Deborah S. Bailey, Director
Planning and Research

DAVID TAUSSIG AND ASSOCIATES, INC.

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MAR 11 1992

CALIFORNIA DEBT
ADVISORY COMMISSION

March 9, 1992

Mr. Steve Juarez
Executive Director
California Debt Advisory Commission
P.O. Box 942809
Sacramento, CA 94209

RE: Comments on the "CDAC Report on Proposed Legislative Changes to the Mello-Roos Act"

Dear Steve:

I appreciate the opportunity to respond to the "CDAC Report on Proposed Legislative Changes to the Mello-Roos Act." Overall I believe CDAC's report is excellent and I commend you for the thorough job you and your staff have done researching Mello-Roos issues. The recommendations made in the report make a positive contribution to the use of Mello-Roos financing.

At the CDAC hearing on Mello-Roos on January 15, I discussed different special tax rates on developed and undeveloped property. I recognize that CDAC has not included proposals on this issue in its recommendations for legislation. I also recognize that my firm has provided you with considerable input on this issue and that you are probably ready to move on to other issues. However, the tax differential between developed and undeveloped property is discussed in your report as an issue for legislative consideration and the remarks in your report concern many of our public and private sector clients.

Steve, I want to emphasize that CDAC's comments about tax differentials between developed and undeveloped property concern our public as well as private sector clients. To give you one example of the public sector's concern, we are now working with three school districts in Central California that are forming a Mello-Roos district to include most of the undeveloped area in their districts. As property progresses in the entitlement and development process, tax levels will be increased, with the highest tax levels on developed property. The special taxes will be used to finance new schools, and inclusion in the district will mitigate school impacts from new development. This type of structure for Mello-Roos districts is increasing in use and is valuable to local agencies' planning efforts; however, owners of vacant land will only agree to join these Mello-Roos districts if special tax rates remain low until they are ready to development their property. Mello-Roos financing has become an important part of the planning efforts of local government agencies and flexibility in apportioning special taxes is critical to this use of Mello-Roos.

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Because of my firm's experience as a special tax consultant in many Mello-Roos districts, we are probably most qualified to discuss tax apportionment issues with you. Accordingly, we have prepared this lengthy—and I hope thorough—letter on developed and undeveloped property special tax rates for your consideration. I have also included a few remarks on capitalized interest.

Tax Differentials on Developed and Undeveloped Land

Mello-Roos is a very flexible financing mechanism. This flexibility is one of the reasons Mello-Roos has become so valuable in California. To understand why this flexibility is critical, it is necessary to understand why Mello-Roos is of such importance in California. In its report, CDAC acknowledges that Mello-Roos was made necessary by Proposition 13. While this is true, there are other reasons that have contributed to the need for Mello-Roos. In the last two decades in California, there has been a considerable expansion in the planning obligations of local agencies. In 1971 the legislature adopted legislation that mandated the general plan as the land use constitution of cities and counties, governing all future development within the community. In 1970, the legislature adopted the California Environmental Quality Act and applied its provisions to real estate development. The last two decades have also seen the adoption of policies of concurrency and the advent of specific plans and large scale planned community zoning.

One result of this increase in planning has been the need for a financing mechanism to implement the plans that are prepared. Mello-Roos is this financing mechanism. Mello-Roos has the ability to ensure that needed public facilities are delivered at the appropriate stages in the growth of developing areas—areas that may build-out over many years. The flexibility of tax rates that adjust to the ultimate build-out of a community and the ability to issue a series of bond issues is critical to the purpose Mello-Roos serves as the implementation mechanism for planned areas.

The importance of this flexibility may not be evident to CDAC. In its report, CDAC stated the following:

> 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. . . . In our view, while this argument is correct mathematically, it does not present a persuasive case for maintaining the status quo. The broader question 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 difficulties faced by issuers in obtaining taxing authority through conventional means.

Mello-Roos districts are designed to provide for service levels many years into the future because general plans require that local agencies be able to provide these services as their communities build-out, and local agencies are required to plan their ultimate build-out. One of the most important attributes of Mello-Roos financing is this ability to accommodate serial bond issuances and to accommodate communities that will build-out over many years.

CDAC recommends that improvement areas be formed in multi-phased projects, so that developed and undeveloped special taxes can be the same. Improvement areas would have little or no effect on the special taxes paid by developers; they would just result in the special taxes being spread over fewer acres. The disadvantage of improvement areas is that the developer may not be able to pledge property with enough value to achieve the necessary value-to-lien. Often to obtain a sufficient value-to-lien, developers must make all of their property subject to special taxes. Developers typically use improvement areas where they are able to obtain a sufficient value-to-lien with only the property in the improvement area.

CDAC suggests that to overcome one of the difficulties that results from the need to phase improvements—consistent tax levels on homeowners—"it is possible to accelerate special tax collections during the earlier stages of the debt service schedule to maintain level tax rates over time." It is not always possible to collect more in taxes than are needed to pay current debt service. Mello-Roos bonds typically cannot be prepaid for at least ten years, and IRS regulations may limit the amount of excess funds that can be collected. This recommendation by CDAC does not make much sense in any case: it is not designed to save homeowners money, it just levies higher taxes on developers. Since developers usually pass all of their costs on to home buyers. this recommendation by CDAC would increase the price of homes to the consumers CDAC intends to help, without saving them anything in taxes.

CDAC has made these recommendations that would reduce the flexibility of Mello-Roos because it believes that homeowners are subsidizing developers. I do not believe this to be true.

CDAC stated in its report that "in practice, most Mello-Roos special tax formulas tax undeveloped properties at lower rates than developed properties." This is not necessarily accurate. The maximum tax *rate* on undeveloped property must be at least as high as the maximum tax *rate* on developed property to ensure sufficient tax revenues to pay debt service if the community does not build out as quickly as anticipated. If the maximum special tax rate on undeveloped property were lower than the maximum special tax rate on developed property, and the property did not build out as quickly as anticipated, there would be a risk that special tax levels would be inadequate to pay debt service. In practice, because improvements are often phased and oversized for early phases, the maximum special tax rate on undeveloped property is often much higher than the maximum special tax rate on developed property.

The special taxes actually levied—as opposed to the maximum special tax rate—may be higher on developed property than undeveloped property, because special taxes are generally levied on residential property first and then levied on undeveloped property to a sufficient level to pay the balance of debt service not paid by developed property special taxes. This is done to minimize fluctuations in developed property special taxes and to make the special taxes on developed property consistent and predictable from year to year; however, levying special taxes on developed property in this manner does not result in developed property paying more than their fair share of special taxes or in a subsidy to developers. This apportionment methodology usually results in special taxes being levied so as to approximate the benefit received.

For example, in a community of 5,000 homes, the first phase may only include 500 homes, or ten percent of the total. Improvements will be installed to serve these 500 homes, but will usually be oversized to serve future phases, so that more than ten percent of the total improvements for the community will be installed in the first phase. (Developers endeavor to minimize the excess improvements required by early phases; however, inevitably, improvement costs are front-loaded to the early phases of a development.) Developed property special tax rates will have been set so that the homeowners in the first phase pay only ten percent of the total special taxes that can be levied in the community at ultimate build-out, equal to the improvements necessary to serve these homeowners; however, since more than ten percent of the improvements have been installed, the developer will be required to pay for improvements that serve future phases of the community. Individual homeowners will also only pay their fair share of special taxes. Each homeowner will pay approximately one five-thousandths (1 ÷ 5,000) of the total special taxes that can be levied in the district at build-out, equal to each homeowners approximate share of the improvements necessary to serve the community. In a phase that is fifty percent build-out, the existing homeowners will pay for fifty percent of the improvements necessary to serve this phase; the developer will also pay for fifty percent of the improvements necessary to serve this phase and will pay for all of the improvements necessary to serve future phases (until homes are sold in future phases). The result is that taxes are levied so as to approximate benefit received and each homeowner pays only their fair share of special taxes.

Special taxes levels may give the appearance that developed property is paying a much higher special tax than undeveloped property. This is because undeveloped property special taxes are spread over all of the undeveloped property (including property in future phases that will be public property). In the previous example, the community of 5,000 homes may have consisted of 1,000 acres of land. The first phase would probably have included approximately 200 acres. Undeveloped land taxes, however, would be levied not only on the land in the first phase not yet purchased by homeowners, but also on the 800 acres that are not in the first phase, even though improvements were not yet built to serve this property. The result is that what appears to be a very low tax on undeveloped property may in reality be a very high tax. (If improvement areas were used, the undeveloped property special tax per acre would be much higher, but the total special taxes paid by undeveloped property would be exactly the same.)

Although special tax rates are not set on developed property to reflect a greater benefit, in many cases there would be justification, based on benefit received, for undeveloped property special taxes to be lower than developed property special taxes. Undeveloped property may benefit from the installation of improvements to the property; however, it does not benefit to the same extent as developed property. Undeveloped property does not generate traffic for roads, children for schools, or the use of most other public improvements. Accordingly, developed property clearly receives a greater benefit from improvements than undeveloped property.

The examples of low undeveloped property special taxes CDAC provided in its report ignored the effect of apportionment methodology that results in homeowners only paying their fair share of special taxes, did not consider the amount of undeveloped property that developers may have been paying taxes on, and did not consider the relative benefit developed property receives from improvements compared to undeveloped property, so it is not surprising that CDAC's examples make it appear that developed property is subsidizing undeveloped property. The examples CDAC provides, however, are inaccurate. The inaccuracy of these examples adds considerably to the appearance of "subsidy."

Donald Swift stated that developers often put 30 homes on an acre of property, and then referred to an example where the average developed property special tax is $1,000 per home and undeveloped property tax $600 to $1,000 per acre. CDAC used this example to support its argument that homeowners are subsidizing developers, without verifying the accuracy of Mr. Swift's statement. We estimate the average density (of taxable area) in the CFD Mr. Swift referred to in his example to be approximately 5.5 units to the acre, the average special tax on developed property for the 1991-92 fiscal year to be $1,121 per unit (which is also the maximum special tax), and the tax on undeveloped property for the 1991-92 fiscal year to be $2,519 per acre (the maximum special tax on undeveloped property for the 1991-92 fiscal year is $13,919 per acre). At 5.5 units to the acre, developed property special taxes for the 1991-92 fiscal year equate to approximately $6,165 per acre, compared to $2,519 per acre on undeveloped property. This does not take into consideration, however, that the improvements in this CFD are being installed in phases, and as a consequence, the developer is paying special taxes on several thousand acres of land that are not yet served by improvements, and will not be served for many years. Undeveloped property is also paying special taxes on acreage that will eventually become public property (streets, parks, open space, etc.) and will never be developed. If undeveloped property special taxes were spread over only the property served by the improvements, undeveloped property special taxes would be much higher than developed property special taxes.

CDAC also quoted Mr. Swift as testifying that "one bond consultant estimates that the landowner/developer will pay less than three percent of the total debt service" in a particular CFD. We are not told which bond consultant said this or how they arrived at this estimate. Considering that improvements are phased to at least partly match home sales, and that debt service will be paid for many years after the CFD is built-out, it would not be surprising to expect a developer to pay no more than three percent of total debt service over the life of a Mello-Roos district. However, based on calculations prepared for the administration of special taxes for the 1991-92 fiscal year, undeveloped land special taxes in the CFDs in the community Mr. Swift referred to are likely to be in excess of twenty percent of total debt service over the life of the Mello-Roos districts.

In its report, CDAC also used the Lake Elsinore Unified School District CFD as an example to demonstrate that developed property subsidizes undeveloped property. In its example, however, CDAC assumed that densities in the Lake Elsinore CFD were twelve units to the acre. In fact, densities (of net taxable acreage) are less than 2.5 units to the acre. It should again be remembered that the improvements in Lake Elsinore are being installed in phases, so the developer is paying special taxes on land not yet served by improvements.

A correction also needs to be made in the information I presented at the CDAC hearing on Mello-Roos on January 15. I presented information showing special tax rates in Lake Elsinore as a percentage of assessed value. The percentages were based on estimated property values, not assessed values. Additionally, the point of my example was to show that developers are much worse off paying for improvements financed with Mello-Roos bonds than they would be for improvements financed with general obligation bonds, the traditional method of financing general benefit improvements.

In its report, CDAC also quoted the testimony of Carla Stalling, who stated 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." If a community or phase is substantially sold-out by the end of the capitalized interest period, obviously, the developer would pay little or no special taxes. This would only occur, however, if the homes in the community or phase were substantially sold-out by the end of the capitalized interest period. This is not a typical situation; for example, in one of the CFDs in the community Mr. Swift referred to, for the 1991-92 fiscal year, total undeveloped land special taxes are $5,857,611, while developed property special taxes are $1,494,913. Ms. Stalling provided no information on the percent of the projects—or of a phase, if a phased project—that were sold out. Her testimony does not provide a meaningful example unless this information is known.

High absorption rates were common a few years ago, and as a result, Ms. Stalling may have seen projects that were substantially sold-out by the end of the capitalized interest period. Absorption rates are much lower now, and it is unusual to see projects sold-out by the end of the capitalized interest period. The credit problems currently being experienced by Mello-Roos are a result of the slower absorption rates now being experienced in the real estate industry. (One analysis we have seen demonstrated that undeveloped land special taxes would double with a twenty-five percent decrease in the absorption rate.) Increased undeveloped property special taxes would greatly add to the credit problems.

The argument that homeowners are subsidizing developers is also contradictory to market economics. Developers must pass on all of their costs on to consumers and make a sufficient return on capital, or they will not be able to stay in business. Some have argued that developers do not set prices, the market sets prices, and that developers price their homes to the market, and as a result, developers do not pass on their savings to home buyers through lower prices. It is true that the market, and not developers, sets the prices for homes. However, developers plan the product they build based on market prices and their expected costs. If a developer incurs a cost that is not expected, the developer will probably not be able to pass the cost on to home buyers. But developers will plan their product to pass on all expected costs to home buyers, otherwise they will not stay in business for long. It is also true that developers price their homes to the market. Competition to sell homes and to buy land will usually result, however, in developers passing on their cost savings to home buyers. If developers anticipate higher undeveloped property special taxes, they will plan their product so that these costs will be passed on to the home buyer. In most cases, whatever the level of undeveloped land special taxes, all of the costs incurred by developers are passed on to home buyers. And in most cases, if developers pay less in undeveloped property special taxes, eventually, as a result of competition with other builders, these cost savings will be passed on to home buyers.

This is not to argue that developers are never subsidized by homeowners as a result of low undeveloped property special taxes. If CDAC were able to identify when inequities occur, and if CDAC knew of a remedy to the situation, and the remedy would not otherwise be detrimental to the use of Mello-Roos, then these inequities should be remedied. But identifying when an inequity occurs is difficult. And the remedies proposed by CDAC would not remedy the situation, but would instead create new inequities. Additionally, the remedies proposed by CDAC would be severely detrimental to Mello-Roos financing.

CDAC has recommended that disclosure to homeowners should include information on the special taxes paid by undeveloped property. Given the difficulty CDAC has had in understanding how special taxes are apportioned, homeowners would certainly only be confused by such disclosure. As already explained, homeowners are not subsidizing developers and no worthwhile objective is served by trying to make homeowners think that they are subsidizing developers. As long as home buyers are aware of the special taxes they will have to pay, and these special taxes are consistent from year to year, the level of special taxes on undeveloped property is not relevant to the home buyer's purchase decision.

Capitalization of Interest

CDAC recognizes the need for capitalized interest "to cover debt service during the time that the county assessor is adding the special tax to the tax rolls." CDAC estimates that "a period of one year should be adequate for this purpose." Eighteen to twenty-four months are actually needed to ensure that tax collections have been received in time to pay debt service. For example, if bonds are sold in September, special taxes cannot be levied until the following fiscal year (which will begin the following July). The first payment of special taxes will not be received until the following December, and the first payment on the bonds that can be paid by special taxes is the payment occurring the following March, a full eighteen months after bonds have been sold.

Providing sufficient time to ensure that tax collections have been received in time to pay debt service is only one of the reasons, however, for capitalized interest. CDAC has recognized that "capitalized interest clearly can improve the credit quality of bonds." Practically all forms of construction loans include interest carry for the construction period. This is done to protect the lender: an almost worst case scenario for a lender is to have a loan go into default before construction is completed.

Capitalized interest is an important means of decreasing the risk of default in Mello-Roos districts. The greatest risk of default on Mello-Roos bonds is in the first couple of years after bonds are issued, before homes have been built, and when there is only one or a few property owners. Capitalized interest ensures that funds are available to pay debt service during this high risk period. By decreasing the risk of default, bondholders, homeowners, and local government agencies all benefit.

Out of the $3.5 billion in Mello-Roos bonds issued, only one bond issue has gone into default. This default resulted from funds lost as a consequence of being invested with Executive Life Insurance Company. This excellent record of performance by Mello-Roos bonds has been critical to the continued viability of Mello-Roos financing. This record would not likely have been achieved if all Mello-Roos bonds had been issued with only twelve months of capitalized interest.

While recognizing these benefits, CDAC believes that "capitalized interest can amount to a significant subsidy from home buyers within a CFD to the developer." In most cases, capitalized interest does not cost homeowners anything and is not a subsidy from the homeowner to the developer. Bond proceeds are usually constrained by either a maximum value-to-lien or a maximum tax burden. The public improvements that need to be financed usually exceed the bond proceeds available. Whether the limited amount of bond proceeds available are spent on capitalized interest or on public improvements, total debt proceeds, and therefore, total debt service, is the same and homeowners' tax bills are the same. Additionally, if capitalized interest results in a safer bond issue, the interest rate on the debt will be less, which will save homeowners money.

The benefits of limiting capitalized interest on Mello-Roos bonds are less than often thought. At most, capitalized interest constitutes about 15 percent of a bond issue (when earnings on the capitalized interest account are used to pay debt service). The questionable benefits gained by limiting capitalized interest should not be obtained at the cost of sacrificing the financial integrity—and the continued viability—of Mello-Roos financing.

I appreciate your consideration of these comments. If you have any questions regarding these comments, or would like additional information, please do not hesitate to let me know.

Sincerely,

David O. Taussig
President

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March 3, 1992

Mr. Steve Juarez
Executive Director
California Debt Advisory Commission
P.O. Box 942809
Sacramento, CA 94209-0001

Dear Mr. Juarez:

Thank you for offering us the opportunity to comment in greater detail on the Commission's proposed recommendations regarding Mello-Roos. I'd like to use this opportunity to elaborate on our February 13, 1992 comments regarding Recommendation No. 2, proposed annual reporting requirements. We support the Commission's intent of making measures of a district's fiscal soundness readily available to bond-holders and taxpayers. We are concerned, however, that the specific list of data elements the Commission has proposed to accomplish this will place a costly data-collection burden on issuers statewide, while yielding data of questionable accuracy.

As we noted then, some of the proposed information is only available to us from secondary sources. As an issuer, the only information items on the list which are produced within the County are Development Status Item 3, Capital Projects Status Items 1 and 2, and Financial Status Items 1 - 6. (We are assuming that the "foreclosure actions" to be reported (Item 4) are County-originated only, and do not refer to bank foreclosures on properties within a district.)

The other items, and their most probable data sources are:

<u>Development Status</u>

1. Number of developed residential properties - Developer self-report, checked against permits drawn.

2. Square footage of commercial/industrial - Builder/project manager self-report.

4. Number and value of properties sold - Developer self-report; for re-sales, real estate multiple listing reports (not presently received)

5. Vacancy rates of commercial/industrial properties - Building manager self-report.

6. Percent of CFD developed by land-use classification - Developer self-report.

7. Names and addresses of all property owners who own at least 10% of the assessed valuation within a district - Special computer run, from tax-setting engineer.

None of these parties is presently obligated to provide this information. Compliance with the reporting requirements could be problematic, especially for reports from building managers (Item 5) and real estate sales reports (Item 4), where the data source has no vested interest in informing bond-holders.

<u>Financial Status</u>
7. Overlapping tax rates - Cal-Muni printouts.

We hope this summary is helpful in suggesting the magnitude of the ongoing administrative responsibility CDAC is proposing for issuers.

If we can answer any questions about this information, please contact me (714) 834-3055, or Susan Zepeda, Manager of Public Finance (714) 834-4775.

Respectfully,

Eileen T. Walsh

Eileen T. Walsh
Director of Public Finance & Advocacy

SGZ:ds

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February 18, 1992

Mr. Steve Shea
California Debt Advisory Commission
P. O. Box 942809
Sacramento, CA 94209-0001

RE: Proposed CDAC Recommendations to Legislature

Dear Mr. Shea:

Thank you for the opportunity to review and comment on CDAC's proposed recommendations to the legislature, while they are still in draft.

We endorse the intent of these recommendations, although we have some concerns about their execution. Throughout, we are assuming that these changes, if incorporated into law, would be implemented prospectively, for guidance in the creation of future CFDs, and the future issuance of debt within them. Any effort to constrain existing districts and existing bond issues, mid- stream, could seriously impair the ability of those districts to service outstanding debt and to maintain the covenants to bondholders contained in financing documents.

Other comments on specific recommendations are:

Recommendation No. 1

We strongly support requiring both disclosure to initial homebuyers, and redisclosure to subsequent homebuyers. With regard to disclosure item (4) in the recommended list, it may be a premature effort to address an issue - the comparative benefit from district improvements obtained by owners of undeveloped vs. developed properties - which, as you later note (Other Issues No. 1), may best be deferred for further deliberation.

Recommendation No. 2

Information we obtain on items 4 (number/value of properties sold) and 5 (commercial/industrial vacancy rates) is from secondary sources; we make no independent efforts to verify its accuracy. Developers and merchant

Steve Shea, CDAC
February 18, 1992
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builders within the districts are not presently required to notify us of sales and rentals; the staff time needed to log this information would result in an increase in district administrative costs.
We do not see any problems with collecting the other types of information listed.

Recommendation No. 3

This limitation (1% of value) for all special taxes, is a laudable guideline; in practice, it is harder to define or implement. In Orange County, we structured taxes to adhere to this guideline, only to find that significant downward shifts in pricing of new housing stock in the present market have caused us to break through this intended "ceiling" in some of our long-established districts. Your recommendation that the guideline be one percent of "anticipated fair market value" at build-out, rather than of assessed valuation, may address this concern while creating another: How are these anticipated values determined? How do we avoid penalizing the more conservative issuers, whose lower projections of anticipated value reduce their ability to generate tax revenue today? Assuming this concern can be addressed in some consistent fashion, we do recommend that the tax ceiling be a percent of projected fair market value, derived in a systematic way at the time a district is formed, from current comparable home values confirmed by an MAI appraiser. This standard would recognize that tax rates, as a percent of actual home values, may subsequently rise or fall as home prices fluctuate.

We also recommend that local general purpose government jurisdictions play a stronger role in the coordination of special district debt issues: A local financing review process, which requires special services agencies to coordinate their financings with affected cities and counties, would accomplish this.

Recommendation No. 6

Your discussion in this recommendation addresses substitution or elimination of proposed facilities - we concur that this process should be a visible one. However, we feel deleted projects should be treated differently from facilities which will be developed, but will be funded from another source, reducing the burden on the district. Further, we do not agree with the recommendation which follows: That an election be required whenever costs are ten percent under or over original cost estimates. In today's volatile economy, great savings can be realized in construction costs, through prudent project management. Let's focus on results - that the roads, schools, fire stations get built - and not tie project managers' hands in dealing with construction savings and cost overruns. If a district is contemplating significant delays to facility construction, or leaving some projects unfunded, we would support a public hearing process, to assist the district board in prioritizing proposed uses of limited resources.

Mr. Steve Shea, CDAC
February 18, 1992
Page Thre

With regard to the other issues you have identified for legislative study, we agree with your assessment that these need further deliberation. We would be pleased to work with you in the further examination of these issues.

Respectfully,

Eileen L Walsh
Director of Public Finance & Advocacy

SGZ:hw

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March 6, 1992

Mr. Steve Juarez
Executive Director
California Debt Advisory Commission
P.O. Box 942809
Sacramento, CA 94209-3269

Subject: Proposed Amendments to Mello-Roos Act

Dear Mr. Juarez:

I am a principal in the firm of Economic and Planning Systems. Our firm does extensive work in planning Mello-Roos Community Facilities Districts (CFDs) and in writing the Rate and Method of Apportionment of the Special Tax (sometimes referred to as the special tax formula). This letter summarizes our comments on the Amendments to the Mello-Roos Community Facilities Act of 1982 presented in CDAC's 2/19/92 staff report.

As you know, the Mello-Roos Act provided local government and private developers with a flexible method for financing public infrastructure. In recent years the volume of Mello-Roos CFD bonds has grown to over $3.6 billion. Due to the increased use of this financing mechanism, the need for reform of the Act is clear. In the remainder of this letter, I will summarize the proposed amendments that we agree with, and the proposed amendments that we feel should receive additional consideration.

AMENDMENTS WE SUPPORT

Recommendation #1 - Support

CDAC proposes a detailed "Notice of Special Tax" that must be read and signed by any prospective homebuyer before signing a purchase agreement. We agree that homebuyers should have the benefit of this type of straightforward disclosure. This way homebuyers will know in advance that their total property tax bill will be higher than nearby areas that do not have the Mello-Roos tax. We also feel that it is important to estimate and disclose the principal amount of the tax lien so the homebuyer can compare the total costs of his/her purchase.

Recommendation #2 - Support

In general, we support the idea of an improvement report system for Mello-Roos CFD. Much of this information should be provided in the Annual Special Tax report required as part of the annual levy of the special tax.

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We think, however, that your reporting requirements may require too much information that is not relevant unless bonds are about to be issued. Items 4 and 5, under "development status," may require substantial effort yet have little impact on the status of the CFD. Once bonds are issued, the taxes must be paid regardless of the number and value of properties sold or vacancy rates. Items 4 and 5 are relevant at the time bonds are being sold and should be included as part of an appraisal.

Recommendation #3 - Limited Support

The general concept of limiting the increase of the maximum tax to 2% is reasonable. However, we have several practical concerns in establishing this broad policy.

The first concern is the definition of "Residential Properties." Does this apply to "developed" residential properties, i.e. after building permit is issued or does it also apply to undeveloped residential land as well?

The second concern is in the use of this concept for phased projects. If the definition states that the rate cannot increase more than 2% per year from the first year the developed residential unit is subject to the tax, then this policy will be workable.

However, many school district tax formulas allow for the annexation of additional property to the CFD over may years. If the base tax rate for those units is set at the formation of the CFD and cannot increase by more than 2% per year, then the tax rate for units built several years out will not be adequate to support the loss in inflation which exceeds 2%. The solution for this would be to set the initial tax higher than necessary which would penalize the first units built in the CFD.

We propose a solution that permits the maximum tax rate to increase based on the needs of the infrastructure program until a final map is created for the individual residential parcels. At that point the tax rate would be frozen for those parcels except for a possible 2% annual increase. Homebuyers would know with certainty what their tax rates would be and how much it could increase. However, units built several years in the future would have a tax rate reflective of the inflated construction costs applicable at the time their infrastructure was installed.

Recommendation #4 - Support

Recommendation # 5 - Limited Support

The reallocation of funds must be carefully considered because many of the costs of facilities are based on preliminary engineering estimates. These estimates typically include 30 to 50 percent contingency factors. CDAC would not want to restrict the use of available funds if a project came 30% under budget solely due to engineering estimates.

Enforcing the 20% rule will also be extremely difficult because bidding practices are not consistent with the preliminary engineering estimates.

We recommend that the reallocation of funds be based on a redefinition of the projects to be constructed rather than the cost estimates of such projects. If a four-lane road is changed to a two-lane road, or a water treatment plant is doubled in capacity, then a major change has occurred that might require a vote.

Recommendation #6 - Limited Support

While well intentioned, this recommendation may have severe future consequences, particularly for school financing. Careful wording of any potential legislation will be critical to avoid causing problems that are not intended.

We favor disclosure as the more practical way of handling this problem of direct benefit.

We have significant difficulty with the concept of building facilities that residents of the CFD are not permitted to use. However, having worked for numerous school districts, we understand the problem school districts are faced with in constructing facilities. The Legislature should take other actions in the area of school financing to avoid the situation where a District may tax one area to build school capacity in another area of the District. Approval of ACA 6 would be a good start toward resolving the school financing issue.

Issue #1

The complex structuring of large scale development projects requires significant flexibility in designing the tax formula. Limiting the ability to allocate the tax burden between developed and undeveloped property may create significant problems in marketing the bonds to bond buyers. Bond buyers usually wish to see a diversified tax base and taxes coming from revenue producing properties. If high tax burdens are maintained on undeveloped property, the bond holders will perceive higher risk and require higher interest rates, therefore hurting all tax payers in the CFD.

In the tax formulas that our firm has prepared, we establish a maximum special tax that is fixed and may not increase. It is the annual tax levy that is allowed to vary as long as it does not exceed the maximum special tax. In a typical tax formula, the levy is based on the annual costs encumbered by the CFD in a given fiscal year. These annual costs are typically less than the maximum special tax, especially in the early years of the CFD.

Allowing the actual tax levy to vary has another important advantage: property that is receiving more benefits can be taxed at a higher rate (as long as it is not greater than the maximum special tax) than property that is receiving less benefit. After a CFD is formed, construction of eligible public facilities begins. As these facilities are constructed, various parcels within the CFD are then able to develop. Our formulas usually tax developed properties at their maximum special tax rates or close to those rates, and then tax undeveloped property if there is not enough revenue from the developed property.

This method is fair because developed property is receiving more benefits from the eligible facilities than undeveloped property. It is fair only if the developed property is paying its fair share of cost burden of the project. If its taxes have been set at a rate higher than the fair share cost burden, then taxing these developed properties at their maximum rates is in effect subsidizing other properties. If developed properties are being taxed a rate equivalent to their fair share of the cost burden, then they are being taxed only for the benefits they receive.

CDACs report recommends that the special tax be apportioned based on benefit received and we concur with that recommendation. We think it is appropriate to establish the maximum tax based on the appropriate share of benefit. However, we disagree that developed and undeveloped land should be treated the same within each year's tax levy. We think that developed land should pay its maximum fair share tax because it is fully receiving the benefits from the installed infrastructure. Undeveloped land is not utilizing the facilities and should pay a lesser amount although the benefit in terms of increased value of the improvements should be recognized through a limited tax.

In regard to the conflict between equal tax rates and residential tax stability in multi-phased CFDs, we agree that local officials appear to be relying on the landowner to lock-in long-term public financing for CFDs. However, due to the environmental mitigations required for new development, local officials have a responsibility to assure that the environmental impacts are mitigated over the buildout of a project.

I hope these comments have been helpful in your deliberation.

Sincerely,

ECONOMIC & PLANNING SYSTEMS, INC

Tim R. Youmans

Tim R. Youmans
Principal

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March 6, 1992

Mr. Steve Juarez
Executive Director
California Debt Advisory Commission
915 Capitol Mall, Room 400
Sacramento, CA 94209-0001

Subject: CDAC Report on Proposed Legislative Changes to the Mello-Roos Act; EPS #1097

Dear Mr. Juarez:

Economic and Planning Systems (EPS) has been hired by the City and County of San Francisco to act as Special Tax Consultant for the Mission Bay Project. In that role, we have reviewed the CDAC report on the proposed legislative changes to the Mello-Roos Act. These comments are a supplement to the more general comments provided in a separate leter from Tim Youmans of the Sacramento office of EPS.

Re: Issue #1B:

We agree with the Legislature and the CDAC that there may be reason to be concerned regarding the effects of cross-collateralization of property in CFDs. However, we additionally agree with the CDAC that this concern is not of sufficient magnitude to require the establishment of tax rates of fixed dollar amounts, given the effect on the credit quality of Mello-Roos bonds.

There are many reasons why actual tax rates may differ substantially from the maximum potential rate. Maximum tax rates must be established at the time of District formation. The maximum rates are based on estimates of total costs, interest rates, administrative costs, an allowance for tax delinquencies, and an allowance for contingencies. The rates are also set based on the maximum debt service that will be encountered when all of the bonds are issued. In the early years of a CFD, it is likely that not all potential bonds will have been issued, and actual debt service will be significantly less than the maximum annual special tax for the CFD.

In the case of the proposed Mission Bay CFD, it is possible that this CFD may never issue any debt, due to its nature as a contingent funding source. However, the maximum tax rate must be established based on the assumption that the CFD issues debt to finance all of the CFD's potential facilities. If this CFD is required to collect a fixed tax amount, rather than allowing the rate to vary from zero up to the maximum, the CFD may collect millions of dollars of tax revenue which will never be spent by the CFD, and will have to be returned to the taxpayers in the CFD at the time the CFD is dissolved. This is obviously

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not a realistic alternative. If CFDs are limited to a fixed tax amount, the City and County would unable to utilize Mello-Roos financing to ensure the orderly development of the Mission Bay Project.

I hope that these comments are useful in your deliberations regarding the proposed legislative changes. Please give me a call if you have any questions on these comments.

Sincerely,

ECONOMIC & PLANNING SYSTEMS, INC.

Walter F. Kieser

Walter Kieser
Principal

WFK/nap

WILLIAM C. KATZENSTEIN
COUNTY COUNSEL

PETER H. LYONS
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LUCY I. FURUTA

March 5, 1992

RECEIVED
MAR 6 1992
CALIFORNIA DEBT ADVISORY COMMISSION

Mr. Steven Shea
California Debt Advisory Commission
915 Capitol Mall, Room 400
Sacramento, California 94209-0001

Re: Proposed CDAC Recommendations to Legislature

Dear Steve:

Initially, I want to apologize for being a month late in responding, but a number of competing bond issues that did close in February and are to close in March have consumed virtually my entire time in the last four weeks. I do have comments with regard to certain of the recommendations:

1. Recommendation No. 1 - Notice to the potential purchaser of a parcel.

a. Your policy addresses only residential purchases. The County in its contract with the developer of a CFD requires such notification be given to purchasers of or lessees of commercial/industrial buildings.

b. Our contract with the master developer presently requires the purchaser of a residence or commercial site or the lessee, in a triple net lease situation, of a commercial/industrial building to execute a one page document which acknowledges the existence of the Special Tax, identifies the classification and rate to be applied to the subject property, and acknowledges receipt of a copy of the Rate and Method of Apportionment. This is to be accomplished prior to the individual taking occupancy of the home, building or leased space. Our experience has been that the home owner does not acknowledge that they receive this information when they have in fact executed the document. Also we have experienced a compliance problem with merchant builders, not necessarily in providing adequate disclosure, but the form of the disclosure made does not necessarily conform to that required by the contract with the master developer.

c. Your recommendations as to the content of the disclosure statement causes me concern.

1. A description of the special tax formula can lead to the criticism that it is incorrect or insufficient. The actual Rate and Method of Apportionment should be provided; the buyer can read it and come to his own understanding.

2. The requirement that a description of the facilities and the cost of each be provided is excessive. Presently a list of the general facilities is required in the recorded Notice of Special Tax Lien; more than this is inappropriate. During the construction of the facilities cost overruns could be experienced that require shifts in the budget, a possible deletion or modification of facilities, contribution of monies from the developer, etc. By listing the estimated budget for facilities to be constructed, you are suggesting to the homeowner or taxpayer that he has the right to require that the budget be adhered to and subject the legislative body to legal challenge should the estimated budget be varied. This would preclude the legislative body and its administrative staff from responding to the realities of the construction project with the flexibility and discretion that is required.

3. What is your object in disclosing the amount of capitalized interest and the number of months that it covers. Invariably the purchaser will be acquiring the property after the capitalized interest period has expired; their knowing it was utilized to insure timely payment of debt service on the bond can not be important. For any bond issue which closes after August 10th of any fiscal year capitalized interest for 3 to 12 months is mandatory to carry the transaction until the Special Tax can be enrolled and the Special Tax revenues can be collected and transferred to the fiscal agent following the initial December 10th installment payment. This is a

fact of life and, in reality, is not a gratuitous extension of credit to the developer. The use of capitalized interest on the part of the County is to fashion a bond transaction that is fiscally viable and marketable. To limit its use because it may be perceived by homeowners as improper is simply unwise and could make the issuance of this type of bond financing impossible.

d. Finally you may require disclosure statutorily, but how do you propose that it be enforced? What penalties do you consider appropriate? And, more importantly, who will pay for its enforcement. Your answer will be the CFD, but its only revenue stream is the Special Tax and the administrative expense component thereof. So the homeowners will see their Special Tax rise to enforce a requirement for which no meaningful penalty can be secured. Certainly the Mello-Roos Act and statutory structure providing for land secured financing does not contemplate that the general revenues of the issuing entity are at risk for administering or enforcing such financings. And if general funds became statutorily required to enforce various provisions of the Mello-Roos Act, there would be a real hesitancy on the part of any governmental entity to utilize this type of financing.

2. Recommendation No. 2 - Annual Reporting Requirement

This proposal needs to be significantly reduced or the result will be that the administrative staff on the issuer assigned to the CFD will be spending all of its time preparing a report at great expense, which will be borne necessarily by the homeowner through the Special Tax and the administrative expense component thereof.

In making this recommendation, your staff needs to limit the information to be included to that which is absolutely required and clearly specify that the basis or source of the information is to be a public or other source that is very accessible.

The number of residences and the square footage of commercial buildings for which building permits have been issued is important to determine whether initial absorption projections are valid. And assessed valuation, as shown on the tax roll, is proper to establish that the aggregate tax bill is, in fact, within the two percent range. But market valuation is not and would be expensive to determine even once, let alone on an annual basis. Similarly, vacancy rates with regard to commercial property is not information which is public or can easily be obtained, if at all.

Fund balances, delinquency rates, etc. can easily be obtained and can be supplied without too great an effort.

3. Recommendation No. 3 - 1% limit on Maximum Special Tax Rate

While this is essentially consistent with our County's policy, we couple this policy with the 2% overlapping tax limit. The effect is that the maximum Special Tax is limited between .75% to .90% of assessed valuation because the existing combined taxes will exceed 1%. The problem with a statutory limitation, as opposed to a policy guideline, is that it cannot be varied from even when there are extremely valid policy justifications for doing so.

4. Recommendation No. 4 - 2% escalator

No Comment.

5. Recommendation No. 5 - Issuer having substantial interest in financial facilities.

The objective is valid, but the proposal will not work. In the County we have attempted to address this issue in our policy guidelines. There have been more than one occasion when the percentage of facilities financed that eventually will be owned, maintained and operated by the County has been the smallest percentage for any of the participating entities. We have issued these bonds because a coordinated approach to the construction of all of the facilities consistent with the conditions which the County set on the project is extremely important to the County. We have done so because the affected water district or flood control district desires the County to take the lead. The recommended policy would preclude this and would result in stifling the use of Mello-Roos in situations when it should be utilized.

6. Recommendation No. 6 - Redirection of Funds

Initially, I take exception to a statement made in your initial paragraph. While the legislative body during or following the public hearing may delete certain facilities or services before adopting the resolution forming the District, it may not delete facilities after the formation resolution has been adopted. More than one bond counsel has advised this office that a formal hearing process with notice to all property owners of the deletion is required along with an election. Consequently, I think your recommendation is unnecessary and you should review it carefully with various firms advising issuers on CFD's and the deletion of facilities after adoption of the resolution forming the District.

As to the recommendation, the County has experienced several situations where substantial shifts in the projected budget has occurred to accommodate cost increases as a result of the finalization of the design of a facility or contract bids coming in over budget. There have been occasions when site conditions discovered during construction have resulted in cost increases of hundreds of thousands of dollars. In each instance, the cost increase has exceeded ten percent of the original budgeted amount for the particular facility. In some of these instances anticipated contingencies and cost savings on other facilities have allowed us to meet the aggregate budget for the total project. In other instances, we have had to demand the short-fall amount be paid by the developer. Our ability to do this efficiently and professionally would have been destroyed if we would have had to comply with your recommendation.

7. Recommendation No. 7 - Direct Benefit

How do you propose to legislatively define "direct benefit". Do you feel confident that the legislative definition you advance will satisfy the three or four property owners that testified at the public hearing. Having worked for a public entity for fifteen years, I do not feel that you can draft such a definition. Certainly not in a manner that will satisfy everyone and preclude any derogatory comments. A direct benefit may be shown by some standards to be the proximity of the facilities to the taxed property with access availability during all appropriate hours. But if the property owner has no reason to use the facility in question or does not desire to, he will assert no direct benefit shown that justifies his paying the special tax.

There is a saying that is frequently used by lawyers: "Bad facts make bad law." Essentially, your attempting to make the egregious fact situation expressed by one witness that has not been collaborated by further testimony as an accurate factual representation of the situation nor shown to be occurring to a significant degree in other situations to establish a legislative standard that can not be met or is necessarily required. Personally, the testimony given at the hearing as summarized in your report does not support your recommendation. The testimony of three or four individuals does not justify what your proposing. It indicates a potential problem, but there are hundreds of CFD's in existence and more than one or two should be carefully reviewed by objective third parties before a policy recommendation should be established.

I have not commented on the "Other Issues" portion of your report. The discussion on subsidization of developers would require a substantial amount of time to comment on and require data which I cannot readily produce; although it is available. Let me just say, the statements of Carla Stalling and Mr. Swift were way off base and your dismissal of Mr. Taussig is not justified. I would suggest you go through a very thorough analysis of a variety of special tax formulas with one or more underwriters or bond counsels before you make any further recommendations on this point so you can determine, if in fact, the developer is subsidized to the degree that you suggest.

I thank you for the opportunity to comment and, again, I apologize for the delay in getting these comments to you.

Very truly yours,

WILLIAM C. KATZENSTEIN
County Counsel

Tim Davis
By
Timothy J. Davis
Deputy County Counsel

TJD:cm

EVENSEN DODGE INC

FINANCIAL ADVISORS

RECEIVED
MAR 10 1992
CALIFORNIA DEBT
ADVISORY COMMISSION

March 6, 1992

Mr. Steve Juarez
Executive Director
California Debt Advisory Commission
915 Capitol Mall, Room 400
Sacramento, CA 95814

Dear Mr. Juarez:

Evensen Dodge, Inc. has recently been selected by the City and County of San Francisco to serve as its financial advisor for the proposed Mission Bay Development Community Facilities District. Laura Wagner-Lockwood of the City's Office of the Chief Administrative Officer asked us to provide comments on CDAC's Mello-Roos legislative recommendations, particularly as to how they might affect San Francisco and the Mission Bay C.F.D. Tim Schaefer and I prepared the enclosed memorandum in response to this request.

Laura Wagner-Lockwood has asked that we provide you with a copy of this memorandum so that the City's views of the legislative recommendations may be reflected to CDAC.

As you may know, the Mission Bay Development in San Francisco is one of the largest mixed-use development projects underway in the United States. Briefly, the project covers 313 acres in an area less than a mile southeast of San Francisco's financial district. Proposed for development are over 8,500 residential units; 6-8 million square feet of office, commercial, hotel and retail space; 63 acres of park and significant highway and other infrastructure improvements. The City signed a development agreement with the developer, Catellus Development Corporation, just over a year ago. The City is proposing to form a community facilities district (or several C.F.D.s) for this project to fund with Mello-Roos bonds the cost of public improvements in the form of project-serving infrastructure, basic subdivision, or in-tract, infrastructure, and hazardous waste clean-up. Total financing needs may well exceed $100 million. It is likely that the initial C.F.D. may be formed within a year.

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Due to the large scope of the development and the uncertainties related to when the various development stages will be phased in, the City faces a challenging task in developing a financing plan for the district. Such issues as taxpayer equity and apportionment of the special tax will need to be addressed.

The proposed changes to Mello-Roos financing will most certainly have varying levels of impact on the Mission Bay C.F.D. and on how the City will proceed in developing its policies and financing strategy for the district. Consequently, the City will very much want to remain actively involved with CDAC in the implementation of any new Mello-Roos changes. We hope the attached will provide some useful initial feedback from the City.

Sincerely,

EVENSEN DODGE, INC.

Richard Morales

Richard Morales
Vice President

RM/cp

enclosure

cc: Laura Wagner-Lockwood
City and County of San Francisco

EVENSEN DODGE INC

MEMORANDUM

TO: Laura Wagner-Lockwood
Office of the Chief
Administrative Officer

FROM: Richard Morales
Tim Schaefer

DATE: March 5, 1992

RE: Comments on CDAC's Mello-Roos Legislative Recommendations

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You have asked for our thoughts on the legislative recommendations which arose from CDAC's hearings on Mello-Roos financings earlier this year, particularly in light of the proposed Mello-Roos for the Mission Bay Development. This memorandum follows the recommendations in the order in which they were published. We have also indicated in some of our comments the thoughts of other members of the CDAC Technical Advisory Committee (TAC).

Recommendation #1

Improving Disclosure

We agree with the CDAC staff here. Most of the developers we have worked with hold the opinion that the mere presence of evidence of the special tax lien in the "white sheet" (the subdivision report required by the California Department of Real Estate) provides sufficient disclosure of the nature of the tax. We do not agree.

In fact, properties that are sold as resales have no "white sheet" requirement and accordingly the only certain disclosure relative to the Mello-Roos tax that a home buyer would receive would be in the preliminary title report provided in connection with title insurance applications.

Though the staff's comment about "hidden subsidies" provided to developers in some Mello-Roos financings is well taken, it was the TAC's opinion that it is not the primary downside to an uninformed purchaser. We maintain that there could be an even greater downside effect on the actual security of the bonds as a result of improper disclosure. Buyers of property in California spend considerably more of their disposable income on housing than people elsewhere in the U.S. This financial leverage assumes that mortgage payments, utilities and tax payments are predictable.

To the extent that a Mello-Roos tax, or the potential for its increase, is inadequately disclosed, one could argue that taxpayers might not have adequate financial capabilities to make payments, and that some inferential impairment of the strength of the security for the bond pledge has occurred.

These recommendations are particularly relevant to San Francisco because it is likely that the audience of buyers for Mission Bay will probably not have the same familiarity with Mello-Roos that Southern California home buyers do. Mello-Roos has had significantly more history and exposure in Southern California. The concept of a Mello-Roos special tax is probably quite foreign to your typical Mission Bay home purchaser.

Recommendation #2

Annual Reporting Requirement

This recommendation provoked the most animated debate among TAC members. The general consensus was that this was a "too far, too fast" recommendation.

Notwithstanding that, the fact remains that "follow-through" information is very hard to come by and, according to testimony at the hearing, is usually available primarily to those investors or interested parties who have the time, the sophistication and the zeal to pursue it.

Specifically, the information on the *development status* as recommended in Nos. 1,2,5 and 6 appears to present an administrative nightmare. Nos. 3,4 and 7, while not easy to provide, do provide for some basic sense of how rapidly development is occurring and how quickly the property is diversifying.

We concur with the staff's recommendations in *capital projects status* without exception.

As to items in *financial status*, only No. 4, foreclosure actions, gives us trouble, and then only because we do not think that we or the staff knows just what it means.

Finally, we agree emphatically with the concluding remark that a CFD should be required to file an addendum to the report in certain default or financial stress situations.

There is no question that these reporting requirements would result in a tremendous administrative burden on the staff of even the most sophisticated public jurisdictions, such as San Francisco. Particularly now when municipal budgets are being trimmed, the last thing that a public jurisdiction needs is to add more staff to handle the reporting. A consideration would be to allow for the increased administrative cost to be budgeted annually into the special tax so as to deflect the burden of reporting onto the tax payers, as is done with normal on-going district administration costs.

Recommendation #3

Limitation of Maximum Special Tax and Total Tax Rate (Landowner Approved Financings)

The important distinction here is the landowner-approved nature of the taxes. Though the TAC agreed that this made for good policy, there was no consensus about how good a law it would make.

Interestingly, Steve Zimmerman of Standard & Poor's pointed out that the limitation could actually impair creditworthiness, an event which was not considered by CDAC staff when the recommendation was crafted. We agree with Zimmerman. Though the "2% total tax rate" idea makes for good policy, it does not provide for year to year fluctuations in tax receipts. We think this recommendation needs more exposure and broader debate. Perhaps the best outcome would be some sort of "linkage" of this to the special tax formula for developed/undeveloped land tax rates.

Since Mission Bay will fall into this category, we think San Francisco should be aware of this and ask for, and take part in, any additional debate on this topic.

Recommendation #4

Limitation to 2% of Annual Increases in Tax Rate

The TAC agreed almost unanimously with this item and so do we. We do not see any problems with this vis-a-vis Mission Bay.

Recommendation #5

Substantial Interest

There was spirited debate on this recommendation. It is primarily aimed at developers who "issue-shop", primarily to school districts. At the end of the day, we do not see any danger to San Francisco here, unless developers begin "cutting deals" with the San Francisco Unified School District away from City Hall.

Recommendation #6

Redirection of Funds

Tim Schaefer was uncomfortable in advising CDAC staff to push this issue. Everyone in the business has experienced the phenomenon of "kitchen sinking" a bond issue in order to satisfy bond lawyers that our intended purposes were contemplated at the time of district formation.

Several of the TAC members felt that this is the most important point for disclosure. In other words, effectively saying to property owners: "This is where your Mello-Roos tax dollars will go. If you don't like that, consider not buying here."

Regardless, the political appeal of this, since it purports to establish additional control over the process, is irresistible. In fact, the testimony which fanned the staff up on this issue came from a community representative in Orange County where just such a redirection of funds is about to occur.

This item could be problematic for Mission Bay, where there will be a need to finance a good deal of project-serving infrastructure. If the cost and phasing of the total project list is very specifically set forth at the time of district formation, a development such as Mission Bay will be somewhat restricted with respect to its ability to reallocate funds at some later development phase for such items as project-serving facilities, a goal which in time may be found to be most beneficial for the development.

This item needs to be explored further by San Francisco, and should be made an issue for further exposure and debate, as we are sure that other jurisdictions with large, multi-phased development projects will have similar concerns.

Recommendation #7

Direct Benefit

This is another recommendation which is pointed primarily at school districts. This provoked comment primarily among those TAC members who are involved in school finance.

We have an urge to agree with the CDAC staff on this one. The original intent of the Mello-Roos bill appears to have been to "wedge" this financing tool in between assessment district financing, which is very area or neighborhood specific, and general obligation financing, the most general financing tool of all. It is important to remember that the original Mello-Roos bill anticipated a nexus between burden and benefit, just as the assessment acts do. There is no evidence that the authors ever expected proportionality of interest to reach zero.

This could be of considerable concern to Mission Bay, given the distinct possibility that a good deal of the Mello-Roos financing could be for hazardous waste clean-up. To the extent that Mello-Roos bonds for hazardous waste clean-up are issued which are supported by special taxes on properties which cannot firmly establish proportionality of interest, this recommendation, if enacted into law, could seriously alter the credit apparatus of such a bond issue. This item should also be examined further.

Conclusion

The scope of the Mission Bay Development will be large and expansive. A great deal of uncertainty still remains as to how the development will eventually unfold. The cost of hazardous waste clean-up is still largely unknown, and there is no firm plan yet on how each proposed subdivision, or development node, will be phased in and at what costs with respect to providing the so-called basic subdivision infrastructure, as well as the project-serving infrastructure.

There is no question that the CDAC legislative recommendations will have some amount of benefit for San Francisco when it eventually forms a C.F.D. for Mission Bay and begins to issue bonds for the project (i.e. disclosure; annual reporting). However, due to the nature of the Mission Bay project, as well as other large, mixed-use, multi-phased development projects in the State, we have concerns that some of the legislative recommendations (i.e. Recommendations #3, 6 and 7) may, without further debate and analysis, not necessarily result in the good public benefits that were intended. Further exposure and discussion should be generated on these issues before final promulgation or enactment of new regulations or laws.

In addition, the "Other Issues for Legislative Consideration" which CDAC has set forth will, we believe, have profound impact on Mission Bay, most notably Issue #1, "The Subsidization of Developer by Home Buyers in Mello-Roos CFDs". We agree with CDAC that these issues need much further deliberation and discussion before making specific recommendations.

The Mission Bay working group needs to discuss these issues further and present its thoughts and recommendations to CDAC so that whatever corrective actions are taken will be in the best interests of San Francisco and the Mission Bay project.