CALIFORNIA
DEBT AND
INVESTMENT
ADVISORY
COMMISSION

A REVIEW OF THE

MARKS-ROOS

Local Bond Pooling Act of 1985

Matt Fong
State Treasurer and Chairman

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A REVIEW OF THE

MARKS-ROOS

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California Debt and Investment Advisory Commission September, 1998

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CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

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September 23, 1998

To all interested parties:

On behalf of the California Debt and Investment Advisory Commission, I am pleased to release the Commission's latest report, *A Review of the Marks-Roos Local Bond Pooling Act of 1985.* This study reviews the legislative history of the Act, presents a detailed data analysis, and discusses policy issues raised by the use of the Act. It is intended to provide a clear and objective picture of how the Act has been used and to facilitate deliberations over potential future changes to the Act. This publication is part of the California Debt and Investment Advisory Commission's ongoing efforts to provide educational assistance to state and local government agencies in California.

In evaluating whether changes to the Marks-Roos Act are needed to curb abusive transactions, this study notes that the Act *already* has been amended in recent years - to curb the imposition of excessive fees, to severely restrict blind pools, and to outlaw Roving JPAs." The fact that each of these problems persists in some form indicates a deficiency in enforcement of the law, rather than a flawed statute. The Commission thus calls on the Legislature to provide for better enforcement of the existing Marks-Roos law, echoing the recommendation put forth in the *Report of the Interagency Municipal Securities Task Force.* The Commission believes that the flexibility afforded by the Marks-Roos Act has allowed local agencies to save time, money and effort in their issuance of bonds. Moreover, there appears to be lisle to be gained by undertaking a major reform effort, as what problems do exist are better addressed by law enforcement. Used responsibly, the Marks-Roos Act provides a valuable tool for local officials in carrying out their debt management duties.

Sincerely,

Matt Fong
California State Treasurer

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INTRODUCTION

The Marks-Roos Act provides the statutory authority for financing a variety of public capital improvements, such as water and sewer plants and the backbone infrastructure needed for new development and redevelopment projects, as well as for short-term cash flow borrowing and liability insurance. The breadth and complexity of financing activity authorized by the Act has led to confusion among many public finance practitioners seeking to develop a working knowledge of Marks-Roos financing. This study reviews the legislative history of the Act, presents a detailed data analysis, and discusses policy issues raised by the use of the Act. It is intended to provide a clear and objective picture of how the Act has been used and to facilitate deliberations over potential future changes to the Act.

CHAPTER I: LEGISLATIVE HISTORY

The enactment of the Marks-Roos legislation in 1985 was the culmination of a series of proposals advanced in the early 1980s to afford local agencies greater flexibility in financing public infrastructure. The Marks-Roos Local Bond Pooling Act does not authorize “bond pooling” *per se*; rather, it confers on Joint Powers Authorities (JPAs) a variety of financing powers that may be used to consolidate the financing of several capital projects or for other authorized purposes, including the financing of single public capital improvements. Broadly speaking, the Act authorizes JPAs to issue bonds and loan money to local agencies. The Act provides JPAs with considerable flexibility to structure loan agreements that conform to the statutory and constitutional debt limitations faced by local agencies. Since the financing powers authorized in the Act may be exercised by JPAs only, a local agency must first enter into a joint exercise of powers agreement with one or more other public agencies before it can avail itself of these powers. The necessity of a joint powers agreement has given rise to a new type of JPA – the Public Financing Authority, or PFA - formed solely for the purpose of executing Marks-Roos bond offerings on behalf of one or more of the member agencies of a JPA.

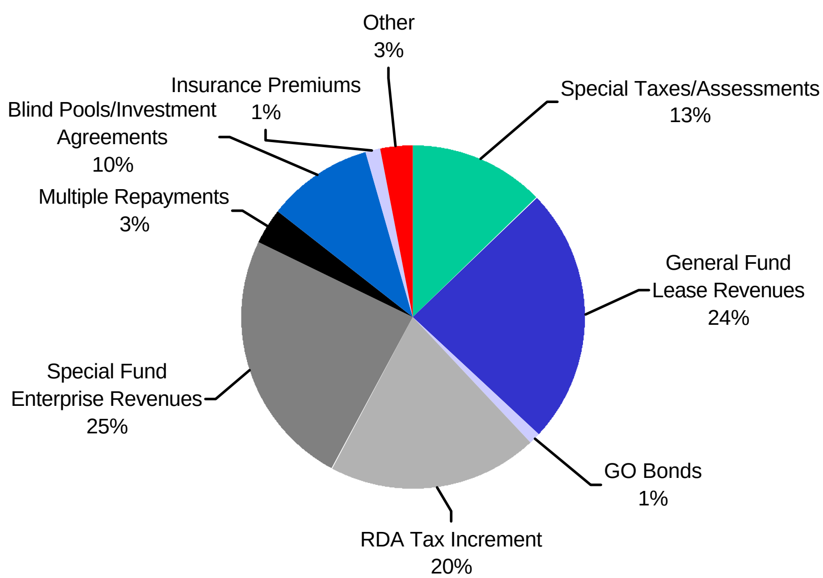
In the past decade, the Legislature has amended the Marks-Roos Act several times to address a variety of abusive practices that have tarnished the image of the Act and in certain instances resulted in financial hardships for communities throughout the state. Most significantly, Senate Bill 1275 (Killea) of 1995 severely restricted the issuance of blind pools under the Act. Additionally, the Legislature has enacted three separate laws intended to curtail the payment of excessive administrative fees to JPAs under the Act, though this practice continues. Finally and most recently, the Legislature enacted Senate Bill 147 (Kopp) in 1998 to prohibit the issuance of bonds under the Act by so-called "roving JPAs." Beginning in 1999, projects financed under the Marks-Roos Act must be located within the boundaries of one of the member agencies of the JPA issuing the bonds.

CHAPTER II: DATA REVIEW

The California Debt and Investment Advisory Commission (CDIAC) staff reviewed official statements for 874 Marks-Roos long-term bond issues sold between 1987 and 1997, totaling $24.4 billion, to elicit information on the sources and uses of funds for each issue. This review indicated that roughly one-half this amount ($12.3 billion) was issued for pooling purposes and the other half ($12.1 billion) was issued to finance single capital projects. In the short-term market, the volume of pooled Marks-Roos tax and revenue anticipation notes (TRANs) has averaged over $1.5 billion annually since 1994.

The Marks-Roos Act differs from other municipal bond laws in that it does not specify a tax, fee, or other revenue source to be pledged as security for bonds issued under the Act. Instead, the Act provides an alternative method of issuing bonds secured by revenues that a local agency derives under separate statutory authority. The chart on the following page illustrates the sources of repayment for Marks-Roos long-term bonds issued during the data review period.

Marks-Roos Long-Term Bonds
Sources of Repayment
1987-1997



Total Issuance = $24.4 billion

As the chart shows, almost one-half of the bonds issued under the Marks-Roos Act during the data review period were secured by general fund lease revenues and special fund enterprise revenues. These bonds most likely would have been issued as certificates of participation (COPs) in the absence of the Marks-Roos Act. Thus, the Marks-Roos Act enables issuers to substitute "bonds for COPs" and achieve more favorable terms with investors. Another 20 percent of the Marks-Roos bond issues included in the data review were secured by the tax increment revenues of redevelopment agencies, who otherwise must issue debt under more restrictive provisions of the Health & Safety Code. All of the remaining repayment sources collectively account for less than 30 percent of the volume of Marks-Roos issuance.

The relative importance of the various sources of repayment for Marks-Roos bonds differ between single project and pooled financings. In general, the sources are more varied for pooled Marks-Roos bond issues, which suggests that pooling economies may be achieved in a number of different sectors of the public finance market. The sources of repayment for single project issues are concentrated special fund enterprise revenues, general fund lease revenues, and redevelopment tax increment revenues.

The statistical analysis of issuance costs under the Marks-Roos Act conducted by CDIAC produced only weak evidence that bond pooling results in issuance cost savings. This analysis, however, understated the benefits of bond pooling, because it was not possible to derive an estimate of the cumulative issuance costs that would have been incurred had each pooled project been financed separately. Had it been possible to formulate an ideal statistical test, it is likely that the issuance cost savings derived from bond pooling would have been greater. The analysis found no statistically significant difference in the cost of issuance between single project Marks-Roos bonds and non Marks-Roos bonds.

CHAPTER III: PUBLIC POLICY ISSUES

Flexibility is the hallmark of the Marks-Roos Act. By simply passing a resolution, a JPA may issue bonds under the Act to finance almost any kind of public capital improvement from almost any local agency revenue source. But the flexibility of the Act is at odds with the philosophy that public borrowing must be carefully controlled, a philosophy that historically has guided the development of California's constitutional and statutory provisions regarding public indebtedness. The various debt restrictions imposed by the Constitution and the organic bond laws of the state – referendum requirements, restrictions on the method of sale, maturity structure, and amount of indebtedness – were enacted to curb excessive borrowing and promote accountability for the borrowing decision. The Marks-Roos Act essentially outflanks these restrictions through its construction as a "complete and supplemental method of borrowing." And while the Marks-Roos Act cannot, of course, allow a local agency to circumvent the constitutional debt limit, it certainly facilitates the use of lease and installment sale financing structures that rely on judicially created exceptions to that limit.

Thus, the Marks-Roos Act raises difficult issues for state policy-makers. Its very presence calls into question the rationale for many existing statutory restrictions on debt issuance. Yet the problems associated with the Act call for a response from state policymakers interested in ensuring the stability of public capital markets. Does the Act need to be “tightened up” to limit its potential for abuse, or can such problems be effectively controlled in another manner?

CDIAC concludes that there is little to be gained by attempting a major reform of the Marks-Roos Act. Used responsibly, it provides a valuable tool for local officials in carrying out their capital budgeting and debt management duties. Accepting the basic statutory framework of the Marks-Roos Act, however, does not represent a retreat from the goal of promoting accountability and responsibility in its use. The Marks-Roos Act *already* has been amended in recent years – repeatedly – to curb the imposition of excessive fees, to severely restrict blind pools, and to outlaw “roving JPAs.” The fact that each of these problems persist indicates a deficiency in enforcement of the law, rather than a flawed statute. In fact, the state’s municipal bond laws – the Marks-Roos Act included – do not assign enforcement responsibilities to any state or local agency, and do not authorize civil or criminal penalties for violations of their provisions. Improving the enforcement of the state’s municipal bond laws should have the effect of deterring aggressive interpretations of the Marks-Roos Act.

INTRODUCTION

After thirteen years, the Marks-Roos Local Bond Pooling Act of 1985 remains an enigma to many bond market participants. People often confuse it with the Mello-Roos Act, but the two laws are in fact very different, notwithstanding their common forebear, former Assemblyman Mike Roos. Much of the confusion engendered by the Marks-Roos Act may be attributed to its versatility - the Act provides the authority for such dissimilar public purposes as short-term cash flow borrowing, liability insurance pools, and the financing of a wide variety of capital projects. Unlike other municipal bond laws, the Marks-Roos Act does not authorize the levy of a tax, fee, or other revenue source to be pledged as security for bonds issued under the Act. Instead, the Act provides an alternative method of issuing bonds secured by revenues that local agencies derive under separate authority. The term “Marks-Roos bond” thus may be used to describe a wide range of public financing activity, and used alone says little about how the bond will be repaid, unlike the terms “general obligation bond” or “Mello-Roos bond.”

As its full title suggests, the Marks-Roos legislation was enacted in large part to provide local agencies with the opportunity to achieve issuance cost economies through bond pooling (i.e., by consolidating the financing of several projects into a single bond issue). But the Marks-Roos Act was not confined to this purpose. Bond pooling was simply the most visible part of a law that conferred broad financing powers on joint powers authorities formed under California law. Perhaps the greatest significance of the Marks-Roos Act is that it sanctioned in law the use of financing leases and installment sale agreements as an alternative framework for public borrowing. In doing so, the Marks-Roos Act gave local agencies the option of marketing these obligations to the bond market as Marks-Roos bonds rather than certificates of participation (COPs).

The public image of the Marks-Roos Act has been tarnished over the past decade by a series of abusive transactions. In the Marks-Roos “blind pools” of the late 1980s, several small communities in the Central Valley issued bonds in amounts far in excess of their financing needs, only to be left with severe financial problems, which in certain instances linger to this day. More recently, California public finance has seen the phenomenon of

Roving Joint Powers Authorities comprised of public agencies who join together to issue bonds on behalf of real estate development projects outside of their boundaries in return for cash payments. The Legislature has enacted restrictions into the Marks-Roos Act in response to these problems. The California Debt and Investment Advisory Commission (CDIAC) believes that the flexibility afforded by the Marks-Roos Act is essential, and that additional restrictions are not advisable. Instead, CDIAC recommends that the abusive practices being perpetuated today under the auspices of the Marks-Roos Act be curbed through better enforcement of existing law.

As is shown in the extensive data review included in this report, local agencies in California have issued over $24 billion in bonds under the Marks-Roos Act to date. The Marks-Roos Act has enabled local agencies to issue debt efficiently and implement cost saving innovations. The proportion of problematic transactions – if indeed the concept could be defined and quantified – would undoubtedly be small, and should not diminish the contributions to the practice of public finance in California made through the Marks-Roos Act.

The greatest policy issue posed by the Marks-Roos Act is that people find it confusing, and do not share a common conception of what it does and does not permit – which may create the climate for abuse. Nonetheless, the Marks-Roos Act itself does not authorize or otherwise encourage financing activity that is inappropriate for local agencies. Thus, the primary goal of this study is to demystify the “black box” of Marks-Roos financing – to provide a factual basis for understanding the historical development of the Marks-Roos Act, and to serve as a reference guide on its practical applications.

CHAPTER I

LEGISLATIVE HISTORY

The enactment of the Marks-Roos legislation in 1985 represented part of the Legislature's response to the widespread concerns over an "infrastructure crisis" in California. By the early 1980s, it had become clear that the combined effects of Proposition 13 and sharp cuts in federal aid to state and local governments were resulting in structural shortfalls in spending for public infrastructure. Local officials faced pressures to maintain visible public services, like police and fire protection, and often found it necessary to balance their budgets at the expense of public works, a category of spending which did not generate the same level of popular support. Proposition 13 also took away the ability of local governments to issue general obligation bonds for public projects, since the local ad valorem property tax rate no longer could be raised above one percent of assessed value.[1] If much of California's post-war growth could be traced to massive investments in public infrastructure, what did this era of fiscal austerity portend for California's future?

Throughout the early 1980s, the Legislature held hearings and issued studies outlining the scope of California's infrastructure deficiencies and identifying policy options. Most prominently, a blue ribbon Task Force established by the Governor released a report in 1984 identifying a $51 billion shortfall in public infrastructure spending over the next 10 years - a big number which drew a lot of attention. Each of these studies, among their many proposals, advanced the concept of establishing a state bond bank to assist local agencies in financing capital projects. The bond bank would be empowered to raise money through the sale of revenue bonds for the purpose of purchasing the bonds of, or extending loans to, local agencies. Essentially, the bond bank would perform a bond pooling function at the state level and pass on cost savings to the participating local agencies. Depending upon the availability of state funding, the bond bank also might

[1] Proposition 46, approved by the voters in 1986, restored the ability of local agencies to levy an extraordinary property tax rate for general obligation bond measures, subject to two-thirds voter approval.

subsidize local borrowing costs or pledge the state's credit to achieve more favorable borrowing terms for local agencies.

The idea of amending the joint powers law to facilitate *local* bond pooling first surfaced in testimony presented by the Association of Bay Area Governments (ABAG) at an interim hearing of the Senate Local Government Committee's subcommittee on Infrastructure and Public Works on November 2, 1983. ABAG had formed a credit-pooling program in 1983, which funded local improvements through the issuance of COPs secured by lease revenues of member agencies. In testimony presented at the hearing, ABAG noted that the further development of its pooling program was inhibited by a provision of the joint powers law which required the passage of an ordinance by each member of the joint powers authority (JPA) prior to the issuance of revenue bonds by an authority.[2] This presented a logistical barrier to the issuance of revenue bonds for pooling purposes for ABAG, which had (and still has) over 100 members. ABAG recommended that the joint powers law be changed to allow the issuance of revenue bonds without the consent of non-participating members, as long as those members and the authority itself did not bear any financial liability for the bonds.

The Roos-Marks Infrastructure Authority Proposal of 1983-84

ABAG's proposal to streamline the approval process for revenue bonds under Article 2 of the Joint Exercise of Powers Law was incorporated into Senate Bill 1166 (Marks) of the 1983-84 session. The ABAG proposal actually was secondary to the main purpose of the bill, which was to establish a state bond bank. Senate Bill 1166, titled "The Roos-Marks Infrastructure Authority Act of 1983", became a two-year bill and eventually was passed by the Legislature, only to be vetoed by Governor Deukmejian on September 26, 1984. The Governor's veto message stated that it would be premature to sign the bill while he awaited the final recommendations of his own Infrastructure Review Task Force. His Task Force ultimately advanced many of the same proposals that had been

[2] Specifically, Government Code Section 6547 reads, "The power of the entity to issue revenue bonds is additional to the powers common to the parties to the joint powers agreement, but shall not be exercised until authorized by the parties to that agreement." The section goes on to state that each local agency shall make the authorization by ordinance subject to the provisions for referendum prescribed in Section 9142 of the Elections Code.

aired in the Legislature, including the ideas of a state bond bank and more flexible bond pooling arrangements for local agencies.

The Marks-Roos Local Bond Pooling Act of 1985

Senate Bill 1166 was reintroduced by Senator Marks as Senate Bill 17 at the beginning of the 1985-86 legislative session, *sans* the bond bank component – it simply included the ABAG proposal to streamline the revenue bond approval process under Article 2 of the joint powers law. The bill passed out of the Senate on March 14, 1985. On May 8, 1985, the Assembly Committee on Public Investments, Finance and Bonded Indebtedness accepted author's amendments to significantly expand the list of projects for which JPAs may issue revenue bonds. This amendment was intended to address a dilemma posed by a private letter ruling of the Internal Revenue Service which stated that entities may issue tax-exempt revenue bonds only for projects explicitly authorized in state law.

Senate Bill 1166 also was reintroduced in its entirety at the beginning of the 1985-86 legislative session by Assemblyman Mike Roos, as Assembly Bill 56. The committee analysis prepared at the time indicated that the author (who served on the Governor's Task Force) introduced the bill as a placeholder with the intent of scrapping its contents and inserting the Governor's bond pooling proposal when ready. On March 23, 1985, AB 56 was amended to incorporate the Governor's proposal, which provided for the creation of "local bond pooling authorities" pursuant to regulations issued by the state Treasurer. Interestingly, the local bond pooling authorities were to be authorized under statutory provisions separate from the joint powers law. In this form, AB 56 passed out of the Assembly in May 1985. The Senate, however, subsequently reconstituted the bond pooling provisions of AB 56 as Article 4 of the joint powers law, scrapping the concept of special bond pooling authorities in favor of joint powers authorities.[3] The Senate also deleted the provision of the bill directing the state Treasurer to develop regulations for the local bond pooling program, and inserted in its place language stating that local

[3] Joint Powers Authorities are special governmental entities created under the Joint Exercise of Powers Law (Government Code Section 6500 et seq) by agreement of two or more public agencies.

agencies may request advice from CDAC (now CDIAC) regarding the formation of bond pooling authorities and the preparation and sale of bonds authorized pursuant to the act.

As the first year of the 1985-86 legislative session wound down, the legislative leadership decided to move the Governor's bond pooling proposal into Senator Marks's SB 17. To effect this change, the Senate failed to concur on the Assembly amendments, which sent the bill to a conference committee. The local bond pooling program was stripped out of AB 56 in the Senate Local Government Committee on August 19, 1985 and inserted into SB 17 by the conference committee on August 22, 1985. The final version of SB 17 codified the Marks-Roos Local Bond Pooling Act of 1985 as Article 4 of the Joint Exercise of Powers Law, and retained the original ABAG proposal to streamline the approval process for revenue bonds under Article 2 of the joint powers law. SB 17 was signed by Governor Deukmejian on September 20, 1985.[4]

Expansion of Joint Powers Authority Financing Powers

Like many laws, the Marks-Roos Act begins by defining the terms that govern its construction and interpretation. Noticeably absent from this list of definitions is "bond pooling" - the financing power that presumably is at the heart of the legislation. Apart from one brief reference, the Act does not even use the term "bond pooling."[5] This is the first clue that there is more to the Marks-Roos Local Bond Pooling Act than meets the eye. Though the concept of bond pooling is straightforward enough – consolidating the financing of several projects into a single bond issue – the Marks-Roos Act was not confined to this purpose. Rather, bond pooling was the impetus for the enactment of legislation that conferred broad financing powers on JPAs formed under California law.

4 Chapter 868, Statutes of 1985.

5 Government Code Section 6584.5 reads in pertinent part, "…it is the intent of the Legislature to assist in the reduction of local borrowing costs…and promote greater use of existing and new financial instruments and mechanisms, such as *bond pooling* by local agencies." [emphasis added]

Broadly speaking, the Marks-Roos Act authorizes JPAs to (1) issue bonds, and (2) loan the proceeds to local agencies. JPAs may issue *Marks-Roos bonds*, as they have come to be called, to finance a wide array of public capital improvements, as well as working capital and insurance programs.[6] Unlike other municipal bond laws, the Marks-Roos Act does not authorize the imposition of taxes or fees to be pledged to the repayment of the bonds. Instead, the Act provides an alternative method of issuing bonds secured by revenues that local agencies derive under separate statutory authority. The proceeds of Marks-Roos bond issues typically are loaned to one or more local agencies for the purpose of constructing or acquiring public capital improvements. The loan agreement between the JPA and each local agency (called the *local obligor*) specifies the terms and conditions of repayment, and pledges the JPA's loan repayment receipts to debt service on the Marks-Roos bonds.[7]

Key Provisions of the Marks-Roos Local Bond Pooling Act

The Marks-Roos Local Bond Pooling Act significantly expanded the financing powers of joint powers authorities (JPAs) in California. The Act authorizes JPAs to

- Issue bonds (Marks-Roos Bonds) and loan the proceeds to local agencies to finance single or multiple public capital improvements, working capital and insurance programs.
- Structure loans to local agencies as lease or installment sale agreements to conform to constitutional and statutory debt restrictions.
- Purchase the bonds of local agencies with the proceeds of Marks-Roos bond issues.

The Marks-Roos Act provides JPAs with considerable flexibility to structure loan agreements that conform to statutory and constitutional borrowing limitations faced by local obligors. Where the constitutional debt limit poses a barrier, the loan may be

[6] "Public capital improvements" is defined in Government Code Section 6546.
[7] The exception would be where a JPA issues Marks-Roos bonds to finance a public enterprise to be owned and operated by the JPA, and the bonds are secured by a lien on revenues generated by the enterprise. Though such "joint-use" facilities historically have been financed under the revenue bond provisions of Article 2 of the joint powers law, a JPA may instead issue bonds under the more flexible Article 4 of the joint powers law (the Marks-Roos Act).

structured as a financing lease.[8] The JPA may serve as the nonprofit lessor, issuing bonds secured by the local obligor's lease payments, or it may acquire the right to lease payments made by a local agency to a separate nonprofit public benefit corporation. Alternatively, the loan may be structured as an installment sale agreement or installment purchase contract to be paid from special fund revenue. Bond issues secured by lease or installment sale agreements rely on judicially created exceptions to the constitutional debt limit and therefore are not subject to the supermajority voter approval requirement imposed by that limit.[9]

Local agencies derive their authority to lease or purchase property through installment payments from laws enacted to facilitate their acquisition and disposal of property. These laws were not originally intended to serve an alternative framework for public borrowing. In response to the need for new financing options in the early 1980s, however, municipal bond professionals pioneered the issuance of certificates of participation (COPs) in leases and installment sale agreements, without explicit statutory authority. The enactment of the Marks-Roos Act thus conferred the Legislature's approval on the use of financing leases and installment sale agreements as an alternative method of public borrowing.[10]

The Marks-Roos Act also authorizes a JPA to purchase, with the proceeds of its bond issue or other revenues, the bonds of any local agency. This power is used primarily in those cases where the local obligor's authority to borrow money is restricted to the issuance of bonds under one of the state's municipal bond laws, as is the case with

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8 Article XVI, Section 18 of the California Constitution prohibits cities, counties, and school districts from incurring indebtedness without two-thirds voter approval.

9 The *Offner-Dean* line of court decisions dating from the 1940s and 1950s established the principle that a binding long-term lease with vesting of title at the end of the term does not create debt subject to the constitutional debt limitation. The courts reasoned that lease obligations, unlike debt obligations, are contingent upon the continued use and/or occupancy of the leased property, and consequently do not represent an absolute and unconditional pledge of revenues. Alternatively, in an installment sale agreement or installment purchase contract, the issuer sells rather than leases the project to the obligor. The installment sale agreement represents an absolute and unconditional pledge of revenues, and therefore a stronger pledge of revenues, than a lease, which is a conditional obligation. Installment sale agreements rely on the special fund exception to the debt limit rather than the lease exception.

10 The Legislature enacted statutes authorizing the issuance of lease-revenue bonds for different purposes in the 1960s and 1970s. But lease-revenue financing did not emerge has a mainstay of local finance until the early 1980s, when agencies began issuing COPs secured by lease and installment sale revenues, a practice that was not explicitly authorized in law.

Mello-Roos Community Facilities Districts (CFDs) and assessment districts. In this financing structure, a CFD or assessment district issues bonds for sale to a JPA which simultaneously issues Marks-Roos bonds. The JPA purchases the Mello-Roos or assessment bond issue with the proceeds of the Marks-Roos issue. The underlying special tax or assessment debt service payments flow through the JPA to the Marks-Roos bondholders (who in effect own the Mello-Roos or assessment bonds indirectly). The end result is the same as in the other techniques described above – the loan simply takes the form of bonds issued by a local agency instead of a loan agreement executed between a JPA and local agency. (A bond is really nothing more than a loan agreement between its issuer and bearer.)

The form of the loan agreement between a JPA and local agency in each instance is tailored to the restrictions on indebtedness faced by the local agency obligor, rather than any restrictions imposed by the Marks-Roos Act itself. The Marks-Roos Act imposes minimal procedural requirements on the issuance of bonds.

Financing Single Public Capital Improvements

The key financing powers authorized by the Marks-Roos Act – to issue bonds and make loans of various types to local agencies – may be used to facilitate bond pooling but are not restricted to this purpose. The Marks-Roos Act also may be used to finance single public capital improvements, as an alternative to issuing bonds under other borrowing laws. Just as a JPA may loan the proceeds of a Marks-Roos bond issue to one or more local agencies to construct or acquire multiple capital improvements, it may loan the proceeds to a single local agency to construct or acquire a single public capital improvement. Just as a JPA may purchase multiple local bond issues with the proceeds of a Marks-Roos bond issue, it may purchase a single bond issue. The authority to finance single public capital improvements is not an implied power – it is stated explicitly in the Marks-Roos Act.[11]

[11] "Bonds may be authorized to finance a single public capital improvement, working capital, or insurance program for a single local agency; a series of public capital improvements, working capital, or insurance program for a single local agency; a single capital improvement…for two or more local agencies…" [Government Code Section 6591 (b)]

On the surface, it would appear that the Marks-Roos Act provides for a rather convoluted method of financing a single project. Instead of directly issuing bonds as under other borrowing laws, a local agency must first enter into a joint powers agreement with one or more other local agencies and form a JPA, prior to issuing bonds. There are two main reasons why local agencies find it worthwhile to finance single projects in this manner.

Flexibility in Issuance

The Marks-Roos Act provides a flexible and efficient method of issuing bonds, the initial expense of establishing a JPA notwithstanding. The procedural requirements for issuing bonds under the Act are minimal – all that a JPA needs to do to is to pass a resolution. Beginning in 1999, each local agency within whose boundaries a public capital improvement is to be located will need to make a finding of significant public benefit, following a public hearing on the matter, prior to issuing bonds.[12] Despite this additional step, the Marks-Roos Act will continue to provide a flexible alternative to borrowing laws that require voter approval, ordinances subject to referendum, or other procedural requirements on the issuance of bonds, or which otherwise restrict the term and structure of bond issues.

In the aftermath of the enactment of the Marks-Roos legislation in 1985, there was uncertainty in the legal community as to whether the Marks-Roos Act truly provided an independent source of bond issuing authority for JPAs, or was merely a supplement to the bonding powers conferred by Article 2 of the joint powers law. If the latter interpretation was correct, the referendable ordinance provisions of Article 2 would have applied to bonds issued under the Marks-Roos Act. Due to this ambiguity, the first bond issuance under the Act did not occur until after the enactment of amendments in 1987 which clarified that the Marks-Roos powers are severable from the joint powers law, and may be exercised in any combination at the discretion of an authority.[13] The independence of the Marks-Roos Act as a source of bond issuing authority was further strengthened by amendments enacted in 1989, which state, in pertinent part:

[12] Senate Bill 147 (Kopp), Chapter 35, Statutes of 1998, will take effect in 1999. The finding of significant public benefit must be made in accordance with the criteria specified in Government Code Section 6586. See discussion of SB 147 on pp. 18-19.

[13] Chapter 481, Statutes of 1987.

> This article shall be deemed to provide a complete and supplemental method for exercising the powers authorized by this article…The issuance of bonds, financing, or refinancing under this article need not comply with the requirements of any other state laws applicable to the issuance of bonds, including, but not limited to, other articles of this chapter. [Government Code Section 6587]

In practice, the flexibility in issuance afforded by the Marks-Roos Act has proven beneficial to a wide array of local agencies. In particular, redevelopment agencies, which face a competitive bid requirement on new issues and advance refundings of tax allocation bonds under the Health & Safety Code, frequently choose to issue bonds under the Marks-Roos Act.[14] Additionally, many JPAs established to provide regional services prefer the Marks-Roos Act to the traditional revenue bond provisions contained in Article 2 of the joint powers law. Revenue bonds issued under Article 2 must be approved by ordinances enacted by all of the parties to the JPA or those who will have projects financed by the bond issuance. The ordinance is required to be published and is subject to referendum for the 30 day period following publication (or 60 days for county members), which delays bond issuance. Another disadvantage of Article 2 is that it requires bonds to be sold at par (with certain significant exceptions), which may prohibit the use of discount instruments that may be attractive to investors and can result in an overall lower cost of funds to the issuer.[15] The flexibility of the Marks-Roos Act, finally, has facilitated the development of structured financial products for the municipal securities market.[16]

Bonds for COPs

As mentioned above, the Marks-Roos Act allows lease and installment sale agreements to be securitized as Marks-Roos bonds rather than COPs. Although the security is identical, many bond industry professionals believe that there is marketing advantage to be gained by substituting "bonds for COPs". Marks-Roos bonds are authorized by law, whereas COPs are issued without explicit statutory authorization. Municipal bond

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[14] Redevelopment agencies are authorized under the Health & Safety Code to issue current refunding bonds through negotiated sale.

[15] Government Code Section 6571 imposes the par bid requirement but allows the governing body of the JPA to sell bonds at less than par for certain purposes if it determines that the sale will result in more favorable terms for the bonds. The exception to the par bid requirement applies to electrical generation and transmission projects, solid waste projects, various transportation projects and certain other projects.

[16] See discussion of *Senior-Subordinate* structure in *Chapter II: Data Review*, pp. 42-43, 45.

investors, reflecting the concern that the validity of COPs may be more vulnerable to legal challenge, in many instances require a premium for comparable Marks-Roos bonds.[17]

The Public Financing Authority – JPA as Financial Intermediary

California's joint powers law, which dates from 1921, was enacted to allow public agencies to develop and administer regional programs through the joint exercise of their common powers.[18] The law enabled local agencies to join together to provide services such as water and power systems that can be delivered most efficiently over geographic regions that usually extend beyond the boundaries of individual local agencies. The joint powers law was amended in 1947 to allow local agencies to form a separate entity – a joint powers authority – with the authority to issue revenue bonds.[19] Both the original bond issuing provisions of the joint powers law (now contained in Article 2 of the law) and the Marks-Roos Act (Article 4) are supplemental powers – that is, they are not derived from the powers that are common to the member agencies of a JPA. A city, for example, cannot issue revenue bonds under Article 2 or Article 4; it can do so only through a JPA.

With few exceptions, the use of the Article 2 revenue bond provisions has been confined to the financing of regional facilities owned and operated by JPAs, such as the water and power projects mentioned above. The Marks-Roos Act is of course a much more flexible law, adaptable to a wider range of purposes. But the projects and programs that are financed through the Marks-Roos Act, for the most part, benefit single local agencies,

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[17] The authority of local agencies to form JPAs and issue Marks-Roos bonds was affirmed by the California Supreme Court in the recently decided *Rider v. City of San Diego* case. In 1996, Libertarian Party activist Richard Rider and associates filed a complaint in Superior Court challenging the issuance of Marks-Roos bonds by a JPA consisting of the City of San Diego and the San Diego Unified Port District to finance the expansion of the San Diego Convention Center. Under the plan of finance, the JPA was to issue Marks-Roos bonds to be repaid with revenues from the City's lease of the Convention Center. The complaint challenged the validity of the lease and the bonds. The plaintiff's arguments were rejected by the trial court and on appeal. On August 6, 1998, the California Supreme Court unanimously rejected the arguments that the proposed financing violated both the city's charter and the state constitution. The decision should assuage investor concerns over the legitimacy of Marks-Roos bonds and COPs, and may dispel any yield differential between the two types of securities.

[18] Chapter 363, Statutes of 1921.

[19] Chapters 1044 and 1045, Statutes of 1947.

and have very little to do with the *joint* exercise of powers. The JPA is simply the vehicle for exercising the financing powers conferred by the Act.[20]

Most JPAs that issue bonds under the Marks-Roos Act are formed exclusively for that purpose. Such “Marks-Roos” JPAs often go by the name of “Public Financing Authority” or “PFA”. For the purpose of availing itself of the Marks-Roos financing powers, a local agency may simply execute a joint powers agreement with a separate local agency under its political control – the most common example being that of a city and its redevelopment agency. This formulation is referred to as a “captive JPA” or “captive PFA” to signify the dominant role played by one of the JPA member agencies.

The Marks-Roos Act thus added a purely financial dimension to the role of JPAs. The semantics of the joint powers law and the complex flow of funds in Marks-Roos financing structures can obscure the fact that most Marks-Roos bond issues are undertaken on behalf of a single local agency, often for a single capital project. In practice, the Marks-Roos Act is nothing more than an indirect, complicated way for a public agency to borrow money – though it is easy to miss the forest for the trees.

Fee Abuses Targeted – Three Separate Times

The Marks-Roos Act authorizes JPAs to charge administrative fees for the purpose of distributing the costs of issuance and administration to the underlying obligors in their bond pools. [21] The levying of excessive administrative fees by JPAs, in amounts far in excess of their legitimate expenses, has been a chronic problem in Marks-Roos financings that has spawned repeated legislative remedies. In essence, some JPAs have taken advantage of their strategic position as intermediaries between borrowers and lenders to siphon off revenues for use unrelated to the projects being financed. The excess fees artificially inflate the costs of financing public capital improvements, and result in taxpayers receiving less value for their money.

[20] As we have seen, early versions of the Marks-Roos legislation designated a state agency and separately constituted local authorities as the “bond pooling” authority.
[21] Government Code Section 6588 (o).

The issuance costs for Marks-Roos bonds are paid up front from the proceeds of the bond sale, just as they are for ordinary, non Marks-Roos bonds. If issuance costs equal three percent of a bond issue, for example, the issuer receives only 97 cents for each dollar that it borrows. The remaining three cents go to pay the underwriter, bond counsel, rating agencies and so on, in much the same manner that a bank deducts points from the principal amount of a home mortgage. Marks-Roos bond issues, like most other types of bonds, also typically establish a reserve fund equal to 10 percent of the bond issue. The bond issue therefore must be sized to provide sufficient funds to pay issuance costs and to establish a reserve fund in addition to the basic costs of constructing or acquiring public facilities. [22] But in paying for issuance costs out of bond proceeds, the issuer is of course using borrowed money. The issuer must pass these costs through to taxpayers by setting the tax, fee or other revenue source securing the bond issue at a rate sufficient to retire debt service on the entire bond issue.

After paying its cost of issuance and establishing a reserve fund, a JPA may have only 85 cents or so for each $1 dollar it borrows available for loans to local agencies. The JPA must be able to distribute the costs of issuance and other common costs to its borrowers; otherwise it will not generate enough revenues to service its debt. But a JPA issuing bonds under the Marks-Roos Act does not directly set the taxes or fees which are pledged to the repayment of its bonds; it simply loans money to local agencies. The provision of the Marks-Roos law that authorizes the imposition of administrative fees simply allows a JPA to pass its issuance and other common costs on to its obligors. There are two ways to do this: (1) by charging each obligor an administrative fee; or (2) by establishing a yield differential between the JPA's Marks-Roos bonds (its cost of funds) and its loans to local agencies.

Senate Bill 2447 Yield Restrictions

During the late 1980s, certain bond professionals developed the technique of establishing large yield differentials in Marks-Roos bond pools as way of generating

[22] If not needed to cover delinquencies during the term of the bonds, the reserve fund is used to pay the final debt service payments. If it is ultimately used to retire debt, the reserve fund is not an added cost to borrowers, even though it increases the size of a bond issue. If the reserve fund is used to cover delinquencies, it must be replenished by the borrowers.

extra revenues for JPAs. A JPA might issue Marks-Roos bonds at a six percent interest rate, for example, and loan out funds or purchase bonds at an interest rate of seven percent or eight percent. These financings were orchestrated by single local agencies through captive JPAs, which enabled the agency in effect to negotiate the interest rates on both sets of bonds and funnel surplus revenues back to its general fund. Typically, the JPA acquired Mello-Roos or assessment bonds, which allowed the cost of the yield differential to be passed on to the taxpayers in discrete financing districts, like a surreptitious tax increase. The prospect of easy money through Marks-Roos yield differentials encouraged the formation of several new JPAs during this time.

The Legislature moved to restrict yield differential abuses in 1990 by enacting Senate Bill 2447 (McCorquodale).[23] Senate Bill 2447 limited the yield on bonds acquired by a JPA to that of the bonds issued by the JPA, with a few exceptions. Most notably, the restriction did not apply to refunding bonds. During the period of declining interest rates in the early 1990s, consequently, many JPAs turned a tidy profit by refunding high-yielding land-based securities at marginally lower rates, thereby redirecting the underlying special tax and assessment payments from bondholders to the JPAs. Certain JPAs reportedly reaped additional profits by diverting the reserve funds on the refunded bonds to purposes other than retiring outstanding debt.

CDIAC conducted a study in 1995 to gauge the effectiveness of the SB 2447 yield restriction, and found that yield differentials actually grew between 1991 and 1993.[24] CDIAC then proposed a new set of restrictions that were incorporated into Senate Bill 1275 of 1995.

Senate Bill 1275 Fee and Yield Restrictions

Senate Bill 1275 (Killea) reiterated that fees charged by JPAs shall be set at a rate sufficient to recover, but not exceed, the JPA's costs of issuance and administration.[25] The law permitted JPAs to establish a yield differential of up to one percent to recover

[23] Chapter 446, Statutes of 1990.
[24] See *Recommended Changes to the Marks-Roos Local Bond Pooling Act of 1985: Report to the Legislature and Governor,* pp. 7-8. CDAC Report # 95-1.
[25] Chapter 229, Statutes of 1995.

the legitimate expenses specified therein, but not to generate profits for a JPA. Unlike the prior yield restriction imposed by SB 2447 of 1990, the SB 1275 yield restriction was extended to refunding bond issues as well.

No sooner was the ink on SB 1275 dry before a variation on the theme of abusive Marks-Roos financing appeared on the scene – the so-called *roving JPA.* Under the Roving JPA model, local agencies form a JPA and issue bonds for real estate development projects in far-flung regions of the state (hence the adjective) in return for the payment of an "administrative fee" to the member agencies of the JPA, in an amount equal to a flat one percent of bond proceeds.

It is standard practice in municipal finance, for Marks-Roos bonds and other types of bonds, to pay issuance costs out of bond proceeds. Issuance costs are paid with borrowed money that must be repaid. The administrative fee provisions of the Marks-Roos Act were intended to provide a way for a JPA to *repay* the money borrowed to pay issuance costs, by passing these costs on to the obligor(s) who ultimately use the funds raised through the sale of Marks-Roos bonds. Administrative fees may also be charged to obligors to cover the ongoing administrative costs of the JPA or member agencies related to the bonds. But the payment of "administrative fees" out of bond proceeds to the member agencies of the roving JPAs has not appeared to be for the reimbursement of issuance costs or legitimate administrative expenses. The issuance costs for the roving JPA bond issues, like other types of bond issues, *already* are paid out of bond proceeds at the time of issuance – these costs do not need to be paid twice. Nor do the roving JPAs themselves appear to exercise ongoing administrative responsibilities that would justify the fees paid to their members. Ultimately, the obligor(s) for these bonds issues, which are usually private real estate developers, must pay for *both* the actual costs of issuance and the ersatz "administrative fee" paid to the member agencies of the roving JPAs.

Assembly Bill 1197 Restriction on Payments from Bond Proceeds

Perhaps assuming that the third time would be the charm, the Legislature enacted further restrictions to the administrative fee provisions of the Marks-Roos Act in 1996. Assembly Bill 1197 (Takasugi) explicitly prohibits the payment of fees to JPAs or their members from bond proceeds in amounts in excess of their costs of issuance and administration.[26] The law was intended to prohibit the abusive fee practices employed by roving JPAs, not to circumscribe a legitimate method of recovering issuance costs and related expenses. Nonetheless, AB 1197 has not deterred the payment of fees to members of roving JPAs from bond proceeds – the practice has in fact increased. After the enactment of AB 1197, the fee payments were recharacterized as "working capital" for the roving JPA member agencies. The Marks-Roos Act authorizes JPAs to *borrow* money for the working capital needs of local agencies, but the money must be paid back. The roving JPA bond issues have not made provisions for the member agencies receiving working capital to repay these funds.

Blind Pools Restricted

The main purpose of Senate Bill 1275 of 1995 was not to restrict administrative fees under the Marks-Roos Act but to address the "blind pool" abuses that occurred in the late 1980s and early 1990s. (The term *blind pool* refers to the issuance of bonds to finance projects that are not identified at the time of issuance.) In several instances, small communities formed JPAs and issued bonds to finance blind pools under the Marks-Roos Act in amounts far in excess of their identified funding needs. The overissuance of debt resulted in severe financial problems for these communities which, in certain cases, continue to this day. The communities involved lacked expertise in municipal finance and may have been persuaded by investment bankers to issue excessive amounts of debt on the basis of unrealistic projections.[27]

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[26] Chapter 833, Statutes of 1996.

[27] The SEC recently filed securities fraud charges against First California Capital Markets, which underwrote many of the blind pool financings in the 1980s, and two of its principals, H. Michael Richardson and Derrick Dumont. Additionally, the SEC recently settled charges against the City of Wasco relating to the city's issuance and management of a large blind pool financing during that time.

In response to this problem, CDIAC developed far-reaching reforms that were incorporated into Senate Bill 1275 (Killea) and enacted in 1995.[28] Most significantly, SB 1275 severely restricted the authority to issue blind pools under the Marks-Roos Act by requiring bond pool proceeds to be loaned out or originated within 90 days of the sale of authority bonds. This was intended to ensure that communities have an immediate need for the funds they borrow under the Marks-Roos Act, making them less vulnerable to pie-in-the-sky development schemes. Additionally, SB 1275 implemented reforms to eliminate conflicts of interest among finance professionals assembling Marks-Roos transactions and implement a suitability standard with respect to investments sold to Marks-Roos bond pools.

Roving JPAs Reined In

The payment of illegal administrative fees is of course what motivates local agencies to form roving JPAs and issue bonds. If the agencies did not profit from their sponsorship activities, they would have no reason for getting involved in development projects outside of their jurisdictions. Nonetheless, the payment of illegal administrative fees is but one of the areas in which roving JPA bond issues have appeared to be out of compliance with the Marks-Roos law. In response to a request from state Treasurer Fong concerning the legality of the roving JPA transactions, the state Attorney General released a letter in August 1996 stating that the transactions were illegal with respect to (1) the payment of fees to JPA members, (2) the inclusion of Indian Tribes as JPA member agencies, (3) the failure to identify the local agencies that will benefit from the financings, and (4) the use of funds for private purposes. The Attorney General's response, however, was in the form of an informal opinion that does not have the force of law.

Senate Bill 147 – Geographic Nexus Requirement

A key problem raised by the issuance of bonds by JPAs for development projects outside the boundaries of the member agencies of the JPA is that there is no local agency to oversee the structuring of the bond issue and the preparation of disclosure

[28] Chapter 229, Statutes of 1995.

documents. This can result in the payment of exorbitant issuance costs and may expose the issuer, however unwittingly, to fraud liabilities under the federal and state securities laws. Additionally, if the project fails, the community in which it is located – which had no involvement in the decision to issue the bonds – is left with the difficult prospect of finding a new developer to take over a project already burdened with excessive bond debt.

To promote the goal of accountability in Marks-Roos financings, CDIAC sponsored Senate Bill 147 (Kopp) in the 1997-98 legislative session. Senate Bill 147 requires a geographic nexus between a JPA and the projects it finances through the issuance of Marks-Roos bonds – the project must be located within the boundaries of one or more of the member agencies of the JPA. Additionally, SB 147 requires that the member agency that is to benefit from the project financing hold a public hearing on the question of public benefit prior to reaching the finding of public benefit required under the Marks-Roos law. The public hearing requirement is intended to provide a safeguard against questionable financing activity by subjecting the question of public benefit to public scrutiny and by establishing a public record of the legislative body's reasons for reaching its finding.

Senate Bill 147 passed unanimously in both houses of the Legislature and was signed into law by Governor Wilson on May 13, 1998.[29]

Summary

The enactment of the Marks-Roos legislation in 1985 was the culmination of a series of proposals advanced in the early 1980s to afford local agencies greater flexibility in financing public infrastructure. The Marks-Roos Act does not authorize "bond pooling" *per se*; rather, it confers on JPAs a variety of financing powers that may be used to consolidate the financing of several capital projects or for other authorized purposes, including the financing of single public capital improvements. Broadly speaking, the Act authorizes JPAs to issue bonds and loan money to local agencies. The Act provides JPAs with considerable flexibility to structure loan agreements that conform to the statutory and constitutional borrowing limitations faced by local agencies.

[29] Chapter 35, Statutes of 1998.

Unlike other municipal bond laws, the Marks-Roos Act does not authorize the imposition of taxes or fees to be pledged to the repayment of bonds. The Act simply provides an alternative method of issuing bonds secured by revenues derived by local agencies under separate statutory authority. Since the financing powers contained in the Act may be exercised by JPAs only, a local agency must first enter a joint exercise of powers agreement with one or more other public agencies before it can avail itself of these powers. The necessity of a joint powers agreement has given rise to a new type of JPA – the Public Financing Authority, or PFA – formed solely for the purpose of executing Marks-Roos bond offerings on behalf of one or more of the member agencies of a JPA.

In the past decade, the Legislature has amended the Marks-Roos Act several times to address a variety of abusive practices that have tarnished the image of the Act and in certain instances resulted in financial hardships for small communities throughout the state. Most significantly, Senate Bill 1275 of 1995 severely restricted the issuance of blind pools under the Act. Additionally, the Legislature has enacted three separate laws intended to curtail the payment of excessive administrative fees to JPAs under the Act, but the practice continues unabated. Finally and most recently, the Legislature enacted SB 147 in 1998 to prohibit the issuance of bonds under the Act by so-called "roving JPAs." Beginning in 1999, projects financed under the Marks-Roos Act must be located within the boundaries of one of the member agencies of the JPA issuing the bonds. SB 147 also will require that the member agency to benefit from a project financing first hold a public hearing on the question of public benefit prior to reaching the finding of public benefit required under the Marks-Roos law.

CHAPTER II

DATA REVIEW

In light of the diverse financing activity authorized by the Marks-Roos Act, one of the key objectives of this study was to develop information concerning how public agencies in California have put the Act into practice. For the purpose of developing a comprehensive database on the use of Marks-Roos financing, CDIAC staff reviewed the official statements for a total of 1,240 joint powers authority bond issues sold between January 1987 and December 1997.[30] This review allowed staff to determine the statutory authority for each JPA bond issuance – the Marks-Roos Act versus Article 2 of the joint powers law and other provisions of law – and to capture detailed information on the sources and uses of funds for each Marks-Roos bond issue.

This chapter first presents data on the volume and purpose of bond issuance under the Marks-Roos Act, and classifies each bond issue as “pooled” or “single project.” Next, this chapter develops detailed information on the revenue sources pledged to the repayment of Marks-Roos bond issues and presents diagrams depicting the key Marks-Roos financing structures. It concludes with a detailed analysis of the issuance costs for Marks-Roos bonds.

Volume and Purpose of Issuance

Joint powers authorities may issue bonds not only under Articles 2 and 4 of the joint powers law, but under other provisions of state law, as well. Table 1 on the following page identifies the sources of statutory authority for JPA bond issuance between 1987 and 1997.

[30] Although the Marks-Roos legislation was enacted in 1985, the first bond issue under the authority of the Act did not occur until 1987. Joint powers authorities sold a total of 1,375 bond issues during the data review period, but 135 were dropped from this analysis because official statements were not available.

Table 1

**Joint Powers Authority Debt Issuance By Type
1987 - 1997**

Authority	Citation	Number of Bond Issues	Amount (billions)
Marks-Roos Local Bond Pooling Act of 1985	CA Government Code, § 6584 et.seq. Article 4, Chapter 5, Division 7, Title 1	874	$24.4
Joint Exercise of Powers Law	CA Government Code, § 6500 et.seq. Article 2, Chapter 5, Division 7, Title 1	124	$14.6
Installment Sale Agreements, Lease Purchase (Non-profit Certificates of Participation)	CA Government Code, §6508, §37350 and other	89	$3.2
Housing Revenue Bond Law	CA Health & Safety Code §52000 et.seq. Chapter 1, Part 5, Division 31	55	$1.3
Other	City Charters, Government Code §53859 et.seq. Title 5 Article 7.7, or not available in Official Statement	24	$0.8
Industrial Development Bond Law	CA Government Code, §91500 et.seq. Title 10, Chapter 1, Article 1	69	$0.2
Revenue Bond Law of 1941	CA Government Code, §54300 et.seq. Revenue Bond Law of 1941, Chapter 6	5	$0.1
	Total JPA Bond Issuance	**1,240**	**$44.6**

The total volume of debt issued by JPAs listed in Table 1 amounts to $44.6 billion, or 25 percent of the total amount of long-term debt ($182 billion) issued by local agencies in California between 1987 and 1997. The vast majority of these bond issues, 874 of the 1,240, were issued under the authority of the Marks-Roos Act. In terms of dollar volume, 55 percent of the JPA bond issuance is attributable to the Marks-Roos Act ($24.4 billion) and 33 percent to Article 2 of the Joint Powers Law ($14.6 billion). The average dollar amount of the Marks-Roos bond issues, $28 million, fell well below that of the Article 2 bonds, $104 million, due to the financing of several large public power projects under Article 2.

Volume of Long-Term Marks-Roos Bond Issuance

The $24.4 billion of long-term bond issuance under the Marks-Roos Act during the data review period represents 13 percent of the total amount of long-term debt issued by local agencies in the state during that period. Chart 1 below displays the annual dollar volume of Marks-Roos bond issuance between 1987 and 1997.

Chart 1

Long-Term Marks-Roos Bond Issuance 1987-1997

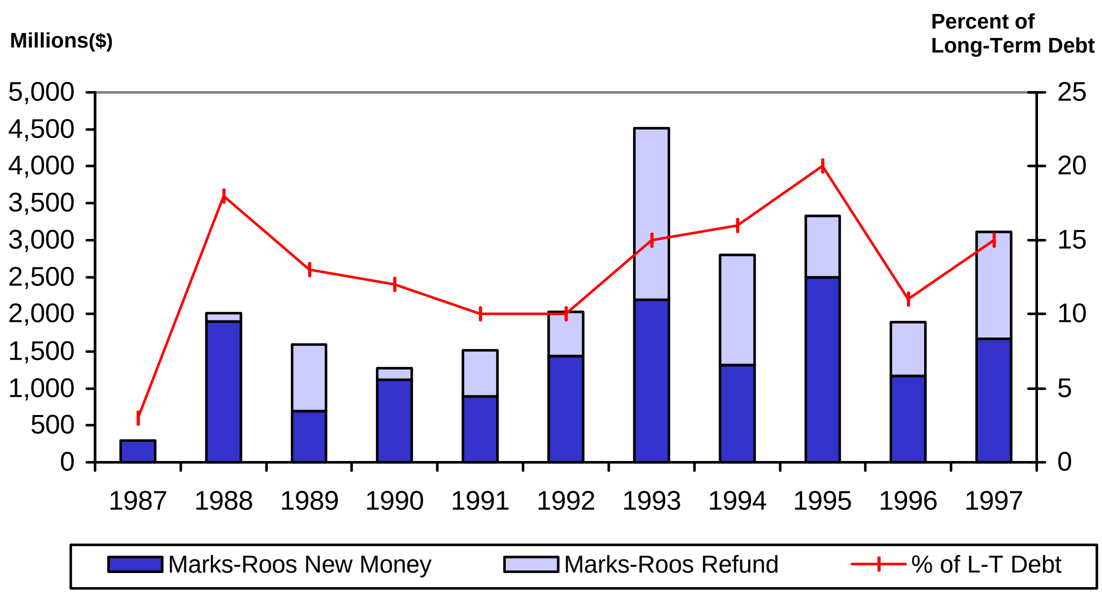


Chart 1 illustrates that Marks-Roos financing has grown in prominence since the late 1980s, and now accounts for about 15 percent of the long-term debt issued by local agencies in California each year. The greater acceptance of Marks-Roos financing by local agencies and investors, coupled with the low interest rate environment of recent years, has fueled the surge in new borrowing and refinancing evident since 1993.

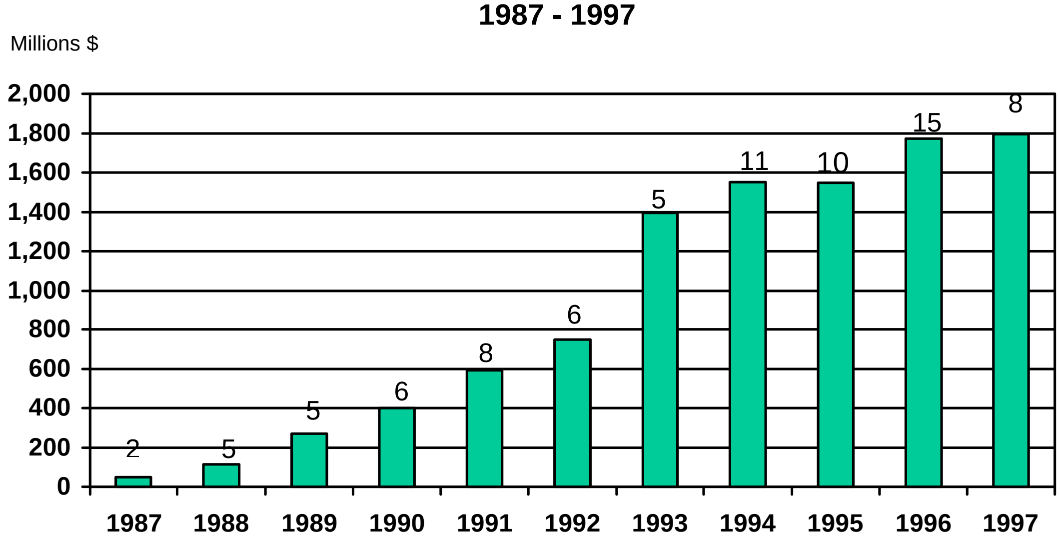
Volume of Short-Term Marks-Roos TRANs Pool Issuance

The largest category of bond issuance each year under the authority of the Marks-Roos Act is short-term tax and revenue anticipation notes (TRANs). Local agencies in California issue TRANs to manage their cash-flows and to smooth out timing discrepancies between tax collections and spending obligations. TRANs typically are issued at the beginning of a fiscal year and mature at the end of the fiscal year.

The large scale pooled TRANs issues assembled by JPAs such as the California School Cash Reserve Program Authority (CSCRPA) and the California Special Districts Association (CSDA) provide local agencies with an alternative to structuring and marketing their own stand-alone TRANs issues. Agencies may choose to participate in TRANs pools for cost savings or simply for ease of administration. The annual volume and number of TRAN pools issued under the Marks-Roos Act is displayed below in Chart 2.

Chart 2

Number and Dollar Volume of Short-Term Marks-Roos TRANs Pool Issues 1987 - 1997



Total Issuance = $10.2 billion

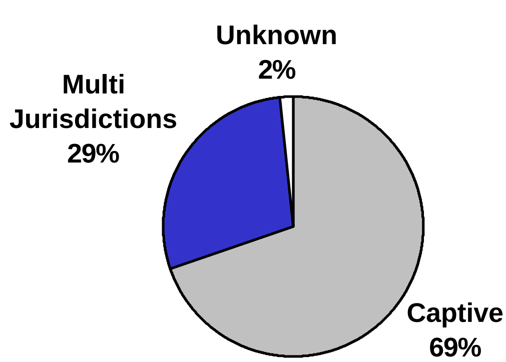
The first two TRANs Pools were issued in 1987 by the San Diego Area Local Government pool, a six member pool for $10.6 million, and the Los Angeles County Schools and Community College District pool, a 12 member pool for $36.9 million. From this modest beginning, TRAN pool issuance has grown to an annual high of $1.8 billion in both 1996 and 1997. Over $1 billion in pooled TRANs have been issued in each of the last five years. (In 1996, a total of 660 local agencies participated in TRAN pools, a number which dropped to 528 in 1997). The pool membership consists of school districts, special districts, cities, counties and community colleges districts, who on average borrow less than $4 million each.

Profile of JPA Membership

The broad financing powers conferred by the Marks-Roos Act may be exercised by JPAs only. JPA membership can be very diverse or very limited. Large statewide JPAs may be open to new members on a continuous basis, whereas in smaller JPAs membership may be fixed initially. As mentioned in the previous chapter of this report, a local agency may enter into a joint exercise of powers agreement with another entity under its political control, forming a “captive” JPA, solely for the purpose of availing itself of the Marks-Roos Act.

Chart 3

Profile of JPAs Issuing Marks-Roos Bonds
1987 - 1997



Total JPAs = 301

The data analysis confirms that captive JPAs account for most of the bond issuance under the Marks-Roos Act. The 874 bond issues included in this study were issued by 301 separate JPAs. As illustrated in Chart 3 on the previous page, captive JPAs accounted for 208, or 69 percent, of those issuers.

Marks-Roos Long-Term Bond Issuance by Purpose

Joint Powers Authorities issue bonds under the Marks-Roos Act for a variety of purposes. Table 2 below presents data on the purpose of Marks-Roos bond issuance for the 1987-97 period.

Table 2

**Marks-Roos Long-Term Bond Issuance by Purpose
1987-1997**

Purpose	Number of Issues	% of Total Marks-Roos Issues	Total Dollar Volume (in Millions)	% of Total Dollar Volume
Multiple capital improvements	250	29	$8,222.7	34
Redevelopment	226	26	4,957.8	20
Power generation/transmission	19	2	2,430.9	9
Miscellaneous	61	7	2,315.0	9
Wastewater collection and treatment	44	5	1,660.4	7
Public buildings	55	6	1,142.4	5
Insurance and pension funds	22	3	778.1	3
Water supply/storage/distribution	47	5	649.5	3
Recreation and sport facilities	26	3	639.4	3
Education	42	5	558.0	2
Solid waste recovery facilities	18	2	482.4	2
Housing	21	2	204.5	1
Street, bridge or highway construction and improvement	22	3	174.3	1
Interim financing for cash flow or projects	21	2	148.3	1
Total	**874**	**100%**	**$24,363.7**	**100%**

The largest category in terms of dollar volume, at $8.2 billion, is “multiple capital improvements,” a catch-all category that unfortunately does not reveal much about the purpose of these bond issues. (A bond issue that finances street, sewer and park improvements would, for example, be reported as “multiple capital improvements”.) Redevelopment projects account for the second largest category, at just under $5 billion, followed by power generation and transmission, at $2.4 billion. Wastewater collection and treatment accounts for $1.7 billion of the total; public buildings at $1.1 billion, followed by a number of categories under $1 billion each.

Pooled vs. Single Project Bond Issuance

Though “bond pooling’ is forever enshrined in the full title of the Marks-Roos Act, the Act authorizes JPAs to issue bonds not only for pooling purposes but also for single public capital improvements, as discussed in the previous chapter. The relative significance of *pooled* versus *single project* financing under the Act thus presented a natural subject for data analysis. The task of classifying the 874 Marks-Roos bond issues in this study into these two categories was complicated, however, by the fact that the law does not define the term *bond pooling,* as discussed in the previous chapter. It turns out that it is not so easy to come up with a workable definition. The challenge, more precisely, is not to define *bond pooling* but to define *local bond pooling* as practiced under the Marks-Roos Act.

Unlike a state bond bank (the *bond pooling* prototype), a JPA does not necessarily issue bonds under the Marks-Roos Act for the purpose of extending loans to separate local agencies or *obligors* for separate projects. A local agency may in effect “pool” its own bond issues under the Marks-Roos Act through a captive JPA. Thus, a pooled Marks-Roos bond issue may have only a single local obligor. Ideally, it would be possible to identify those Marks-Roos bond issues that funded pooled or multiple capital projects for a single obligor by simply reviewing their official statements. However, because the Marks-Roos Act authorizes JPAs to issue bonds for *public capital improvements*, not *projects* per se, a single project might consist of multiple capital improvements. As a result, there is no easy way to determine which of the public capital improvements described in a Marks-Roos official statement constitute distinct projects that otherwise would have been financed by multiple bond issues.

In most instances, it was necessary to look beyond the project description to the underlying revenue stream pledged to the repayment of the Marks-Roos bonds. The proceeds of a Marks-Roos bond issue typically are loaned to a member agency under a loan agreement (that may be structured as a lease or installment sale agreement) or through the purchase of local agency bonds by the JPA. The loan agreement or the bonds purchased by the JPA are referred to as the *local obligation* and provide the security for the Marks-Roos bond issue. Normally, a separate loan or bond purchase agreement is executed for each separate project. Thus, for purposes of this study, *local bond pooling* is defined as those Marks-Roos bond issues that are secured by either multiple local obligors or multiple *local obligations* – any combination of two or more loans, leases, installment sale agreements or local bond issues. Conversely, those Marks-Roos bond issues that are secured by a single local obligor and a single local obligation are defined as *single project* bond issues. This provides for a fairly broad definition of *local bond pooling*, to the extent that local agencies have other options, apart from the Marks-Roos Act, for pledging multiple revenue sources to the repayment of bonds and certificates of participation.[31] Under the definition of pooling used in this study, the Marks-Roos Act is not the sole source of pooling authority available to local agencies, even if it is the most flexible and preferred option.

Table 3

Pooled vs. Single Project Marks-Roos Bond Issuance
1987-1997

Marks-Roos Bond Issues	No. of Issues	Dollar Volume (Billions)	% of Total Volume
Pooled Financings	367	$12.3	50.4
Single Projects	507	$12.1	49.6
Total	874	$24.4	100.0

Using this definition of *local bond pooling*, Table 3 above indicates that pooled project financings accounted for just over one-half of the dollar volume of bond issuance – $12.3 billion, or 50.4 percent – under the Marks-Roos Act between 1987 and 1997. Single project financing accounted for the remaining half, $12.1 billion, or 49.6 percent of total issuance.

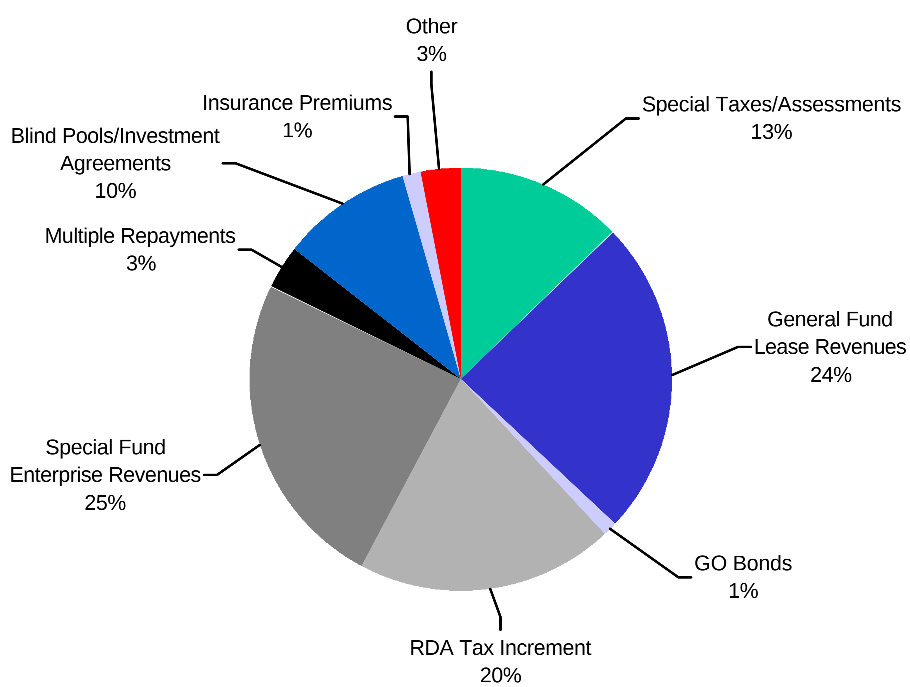
[31] COP issues may be secured by multiple leases, for example, rather than a single lease.

Sources of Repayment

The Marks-Roos Act differs from other municipal bond laws in that it does not specify a tax, fee or other revenue source to be pledged as security for bonds issued under the Act. Instead, the Act provides an alternative method of issuing bonds potentially secured by any of the revenues that a local agency receives. The term "Marks-Roos bond" thus may be used to describe a wide range of public financing activity, but says little about how the bond will be repaid, unlike the terms "general obligation bond" or "Mello-Roos bond."

Chart 4

Marks-Roos Long-Term Bonds
Sources of Repayment
1987-1997



Total Issuance = $24.4 billion

The data evidence the versatility of Marks-Roos financing authority – it is used to finance public buildings, water and power projects, redevelopment projects, and various types of public facilities in new real estate developments. Bonds issued under the Act are secured by a variety of repayment sources, and multiple sources of repayment often are used. As part of its data review, CDIAC identified the sources of repayment (see Chart 4) used for both pooled and single project Marks-Roos bond issues, which are classified below:

- ***General Fund Lease Revenues.*** A JPA may issue Marks-Roos bonds and loan the proceeds to one or more local obligors under one or more lease agreements. The loan is structured as a financing lease to avoid the two-thirds voter approval requirement imposed by the constitutional debt limitation. The JPA may either serve as the nominal lessor and receive lease payments directly from each local obligor, or acquire the right to lease payments made by each local obligor to a separate nonprofit public benefit corporation. Either way, the general fund of each local obligor is the source of repayment for the Marks-Roos bonds. This technique is used primarily for nonenterprise projects – projects such as public buildings that do not generate fee revenues. General fund lease revenues were the source of repayment for 24 percent of the Marks-Roos bonds issued during the data review period.

- ***Special Fund Enterprise Revenues*.** For the purpose of financing a fee-generating or *enterprise* project, a JPA may execute an installment purchase contract (also called an installment sale agreement) or a financing lease as the security for the loans it makes to one or more local obligors. Under an installment purchase contract, the JPA or another entity sells rather than leases the project to the local obligor, which agrees to purchase the project through installment payments.[32] The source of revenue for the installment payments is the fee revenue generated by the enterprise project being financed (such as a water supply or power system) that are deposited in special funds of the issuer. Special fund enterprise revenues provided the source of repayment for 25 percent of the Marks-Roos bonds issued during the data review period.

[32] The installment purchase contract relies on the special fund exception to the debt limit rather than the lease exception.

- ***Redevelopment Agency Tax Increment Revenues*.** As mentioned elsewhere in this report, redevelopment agencies rely on the flexibility afforded by the Marks-Roos Act to issue bonds through negotiated sale, thereby avoiding the competitive bid requirement that applies to new money and advance refunding issues of tax allocation bonds under the Health & Safety Code. A JPA may loan the proceeds of a Marks-Roos bond issue to one or more redevelopment agencies under one or more loan agreements. (Redevelopment agencies have separate statutory authority to borrow money, apart from the power to issue tax allocation bonds under the Health & Safety Code.) Alternatively, a JPA may acquire tax allocation bonds as part of a refunding. However the transaction is structured, redevelopment tax increment revenue is the source of repayment for the Marks-Roos bonds. This repayment category accounted for 20 percent of the Marks-Roos bond issuance during the data review period.

- ***Mello-Roos Special Tax and Special Assessment Bonds*.** A JPA may purchase Mello-Roos bonds and special assessment bonds with the proceeds of a Marks-Roos bond issue.[33] The source of repayment for the Marks-Roos bonds is the special tax or special assessment payments securing the Mello-Roos or assessment bonds. (The JPA "invests" the proceeds of its Marks-Roos bond issue in Mello-Roos or assessment bonds, and the debt service payments on those bonds flow through the JPA to the Marks-Roos bondholders.) Mello-Roos and special assessment bond issues often are pooled under the Marks-Roos Act for the purpose of refunding the debt of several districts simultaneously, in order to realize issuance cost economies. Additionally, both single project and pooled financings may be structured as senior-subordinate lien Marks-Roos bond offerings to achieve a lower cost of funds.[34] Regardless of such structural options, the JPA must purchase Mello-Roos or assessment bonds to effect the transaction. The JPA cannot execute one or more separate loan agreements because Mello-Roos community facilities districts (CFDs) and special assessment districts do not have the authority to borrow money apart

[33] Mello-Roos and special assessment bonds often are referred to as *land-based securities* because they are secured by liens on parcels within financing districts. The use of special assessment is restricted by law to public improvements that provide a direct benefit to the assessed property. Mello-Roos special taxes – which are taxes as opposed to assessments – are not subject to a benefit nexus, and may be used for community-wide or regional public facilities, like schools and freeway interchanges.

[34] See discussion on pp. 42-43, 45.

from the bond issuing powers authorized in the Mello-Roos Act and the various assessment laws. Those laws impose credit standards and procedural requirements that help to protect both local agencies and investors from potential abuse. Mello-Roos and special assessment bonds provided the source of repayment for 13 percent of the Marks-Roos bonds issued during the data review period.

- ***Blind Pools/Investment Agreements.*** The term *blind pool* refers to the issuance of bonds by the JPA for the purpose of funding projects at some time in the future. The projects to be funded may not be identified at the time of the Marks-Roos bond offering; the bond documents may simply specify eligibility criteria for projects to be funded. In such cases, the proceeds from the Marks-Roos bond issue are placed in an investment contract until such time that the funds are needed.[35] In certain large blind pools issued in the 1980s, prior to the enactment of federal and state restrictions, the funds were never loaned out and the issuers ultimately were forced to redeem the bonds. This category accounted for 10 percent of the Marks-Roos bond issuance during the data review period.

- ***Insurance Premiums.*** The Marks-Roos Act authorizes JPAs to finance insurance liability programs. A JPA may self-insure its member agencies by issuing bonds to capitalize an insurance reserve. The member agencies pay premiums to cover debt service on the bonds and operating expenses and any additional contributions needed to maintain the reserves at actuarially sound levels. Insurance premiums provided the source of repayment for just over one percent of the Marks-Roos issuance during the data review period.

- ***General Obligation Bonds.*** In a few instances, local general obligation bond issues have been structured as Marks-Roos bond offerings. This category, consisting of just four bond issues, totaling $271 million, accounted for just over one percent of the Marks-Roos issuance during the data review period.

[35] As mentioned in the previous chapter, Senate Bill 1275, enacted by the California Legislature in 1995, severely restricted the issuance of blind pools under the Marks-Roos Act. Additionally, the Hedge Bond restrictions enacted into the federal tax law in the early 1990s imposed certain restrictions on blind pools.

- ***Other***. A miscellaneous category that includes bond anticipation notes and revenues from private development activity. These revenue sources collectively provided the source of repayment for three percent of the Marks-Roos bonds issued during the data review period.

Single Project Repayment Sources

The total amount of *single project* Marks-Roos bonds issued during the data review period, $12.1 billion, is supported by four significant repayment sources:

- ***Special Fund Enterprise Revenues.*** Fees generated by public enterprises such as water and power systems represent the largest source of repayment, at 41 percent ($5 billion). Some of this amount is attributable to multijurisdictional JPAs financing regional projects under Article 4 (the Marks-Roos Act) rather than the less flexible revenue bond provisions found in Article 2 of the joint powers law. In other cases, the Marks-Roos structure was chosen for marketing purposes – investors prefer to purchase bonds rather than COPs secured by installment purchase contracts.

- ***General Fund Lease Revenues***. The next largest category, at 28 percent ($3.4 billion), consists of financing leases structured as Marks-Roos bond issues instead of COP offerings (again, the *bonds-for-COPs* strategy).

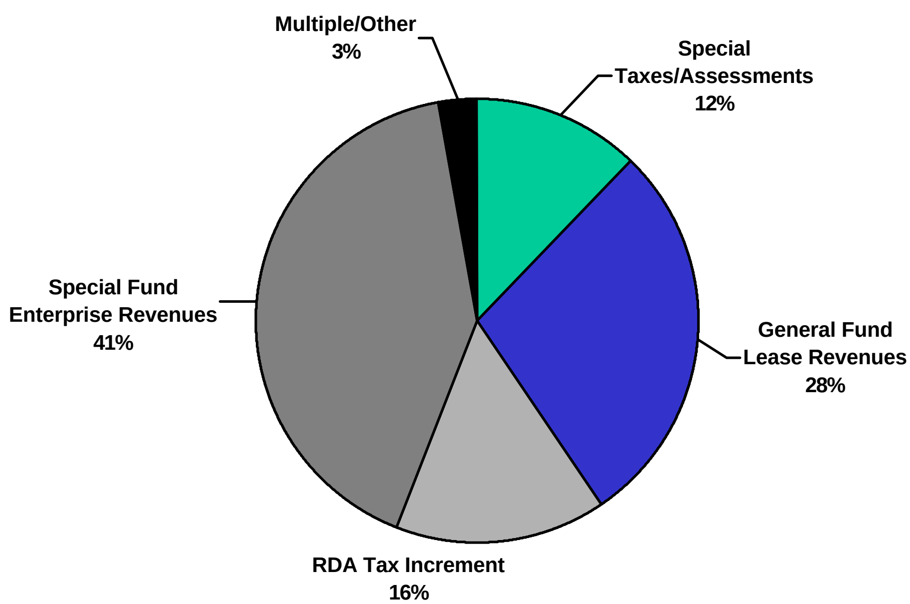
- ***Redevelopment Agency Tax Increment Revenues.*** Redevelopment tax increment revenues account for the next largest repayment source for single project financings under the Act, at 16 percent ($1.9 billion). As mentioned elsewhere in this report, redevelopment agencies issue bonds under the Marks-Roos Act primarily to avoid the competitive bid requirement that applies to the sale of tax allocation bonds under the Health & Safety Code.

- ***Mello-Roos Special Tax and Special Assessment Bonds.*** This is the final major category, at 12 percent of the total ($1.5 billion). This category includes those single project financings structured as Marks-Roos bond offerings to employ the senior-subordinate structure. In other cases, the financing may have been structured in this manner simply to generate "administrative fees" for the JPA.

Chart 5 below breaks down the sources of repayment for single project Marks-Roos bonds.

Chart 5

Single Project Marks-Roos Long-Term Bonds
Source of Repayment
1987-1997



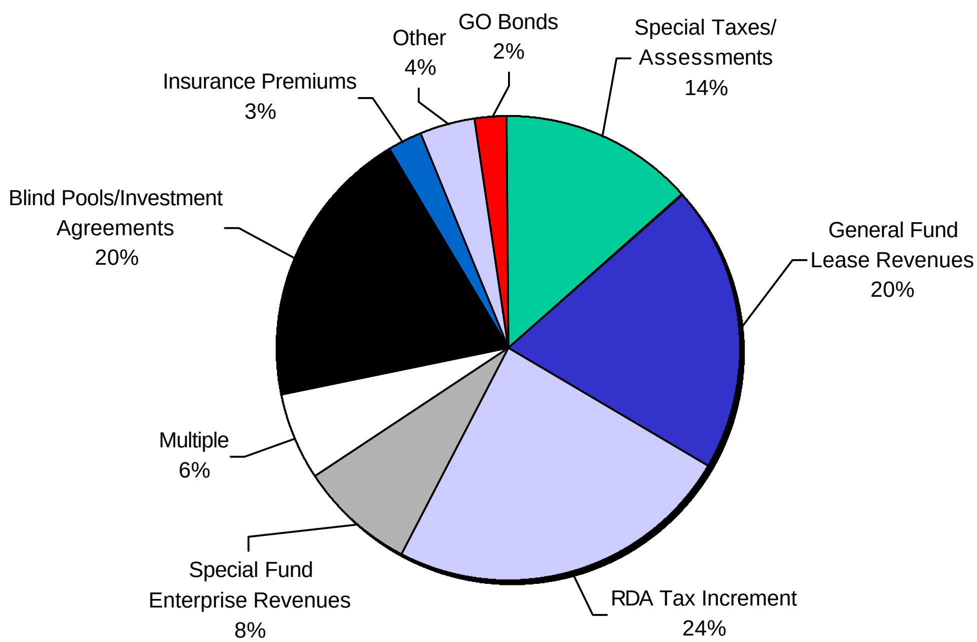
Total Issuance = $12.1 billion

Pooled Project Repayment Sources

As might be expected, there is a greater diversity in the sources of repayment for pooled projects than for single projects, due to the broad range of public financing that can benefit from bond pooling. Single project financings, alternatively, are often structured as Marks-Roos offerings simply to achieve flexibility in issuance.

Chart 6

Pooled Marks-Roos Long-Term Bonds
Source of Repayment
1987-1997



Total Issuance = $12.3 billion

The total amount of *pooled* Marks-Roos bond issuance during the data review period, $12.3 billion, is supported by nine different sources of repayment. In most instances, the bond offerings were structured as Marks-Roos bond issues to achieve issuance cost savings. The categories listed in order of dollar volume are:

- Redevelopment tax increment revenues, 24 percent ($2.9 billion)
- General fund lease revenues, 20 percent ($2.5 billion)
- Blind pools/investment agreements, 20 percent ($2.4 billion)
- Mello-Roos special tax and special assessments, 14 percent, ($1.7 billion)

- The remaining five categories (general obligation bonds, special fund enterprise revenues, insurance premiums, multiple repayment sources and other repayment sources) each account for less than ten percent of the total.

As mentioned, a significant portion of the blind pool amount consists of bonds that were issued in the 1980s under less restrictive federal and state laws and redeemed without originating the proceeds. The Mello-Roos and special assessment category consists mostly of refundings and senior-subordinate lien structures. Chart 6 on the previous page breaks down the sources of repayment for pooled bond issuance under the Marks-Roos Act.

Structural Variations

For the purpose of developing an understanding of how public agencies in California make use of the Marks-Roos Act, a picture may be worth a thousand words. The diagrams on the following pages depict the five basic Marks-Roos financing structures used throughout the state. Figure 1 through Figure 4 vary in terms of the type of JPA – captive or multijurisdictional – and the purpose of bond issuance – single project or pooled project financing. Figure 5 – the Senior-Subordinate Structure – presents an alternative method of structuring the cash flow generated by one or more local obligations pledged to the repayment of Marks-Roos bonds, and may be used in both single project and pooled financings.

- ***Captive JPA – Single Project Financing.*** Figure 1 on page 38 depicts a *Captive JPA-Single Project Financing*. This Marks-Roos financing structure accounts for 29 percent ($7 billion) of the total dollar volume of bond issuance under the Act between 1987 and 1997. A local agency forms a joint powers authority with a separate entity under its political control (the most common example being a city and its redevelopment agency) for the purpose of issuing bonds under the authority of the Marks-Roos Act. The Marks-Roos bonds are secured by a pledge of local revenues that the member agency derives under separate statutory authority. More precisely, the proceeds of the Marks-Roos bond issue are loaned to the member agency under a loan, lease or installment sale agreement, or are used to purchase bonds issued by the local agency. The loan, lease, installment sale agreement or bonds purchased by the JPA are referred to as the *local obligation* and provide the security for the Marks-Roos bonds. The member agency uses the funds it receives from the JPA to pay for the construction or acquisition of public capital improvements.

Special fund enterprise revenues represent the largest repayment source for Marks-Roos bonds issued by captive JPAs for single projects (37 percent), followed by general fund lease revenues (25 percent), redevelopment tax increment revenues (24 percent) and Mello-Roos special tax and special assessment revenues (13 percent).

- ***Captive JPA – Pooled Project Financing.*** Figure 2 on page 39 depicts a *Captive JPA-Pooled Project Financing*. This is the dominant Marks-Roos financing structure, accounting for the largest share – nearly 36 percent – of the total dollar volume of bond issuance ($8.7 billion) under the Act between 1987 and 1997. The only difference between Figure 2 and Figure 1 above is that the proceeds of the Marks-Roos bonds are being used to fund multiple projects rather than a single project. The multiple projects are pooled into a single Marks-Roos bond issue secured by multiple local obligations that may be derived from one or more local revenue sources.

  Redevelopment tax increment revenues represent the largest repayment source for Marks-Roos bonds issued by captive JPAs for pooled projects (30 percent), followed by general fund lease revenues (22 percent), Mello-Roos special tax and special assessment revenues (17 percent), blind pool/investment agreements (13 percent), and three categories of less than ten percent each.

Figure 1

Captive JPA – Single Project Financing

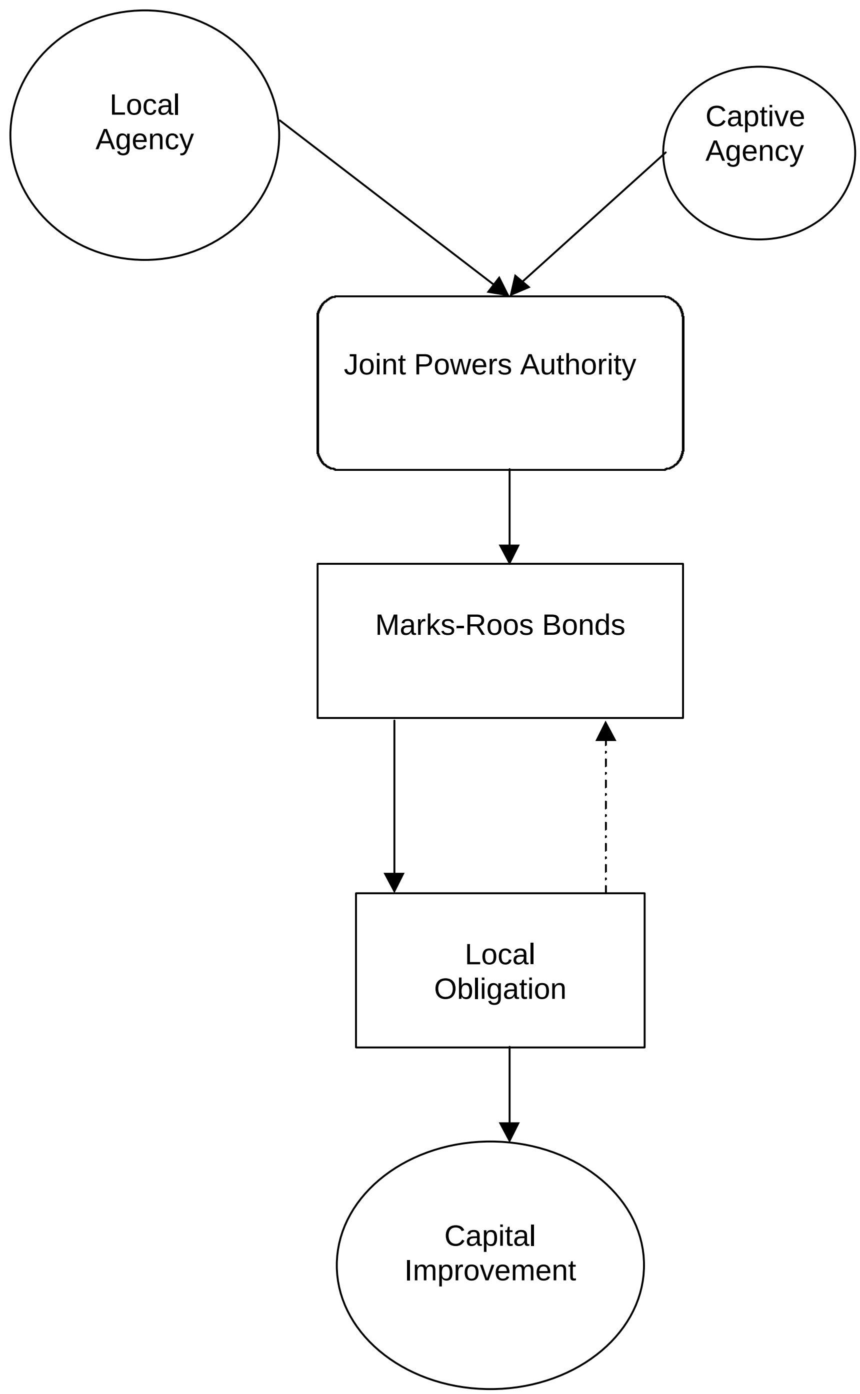
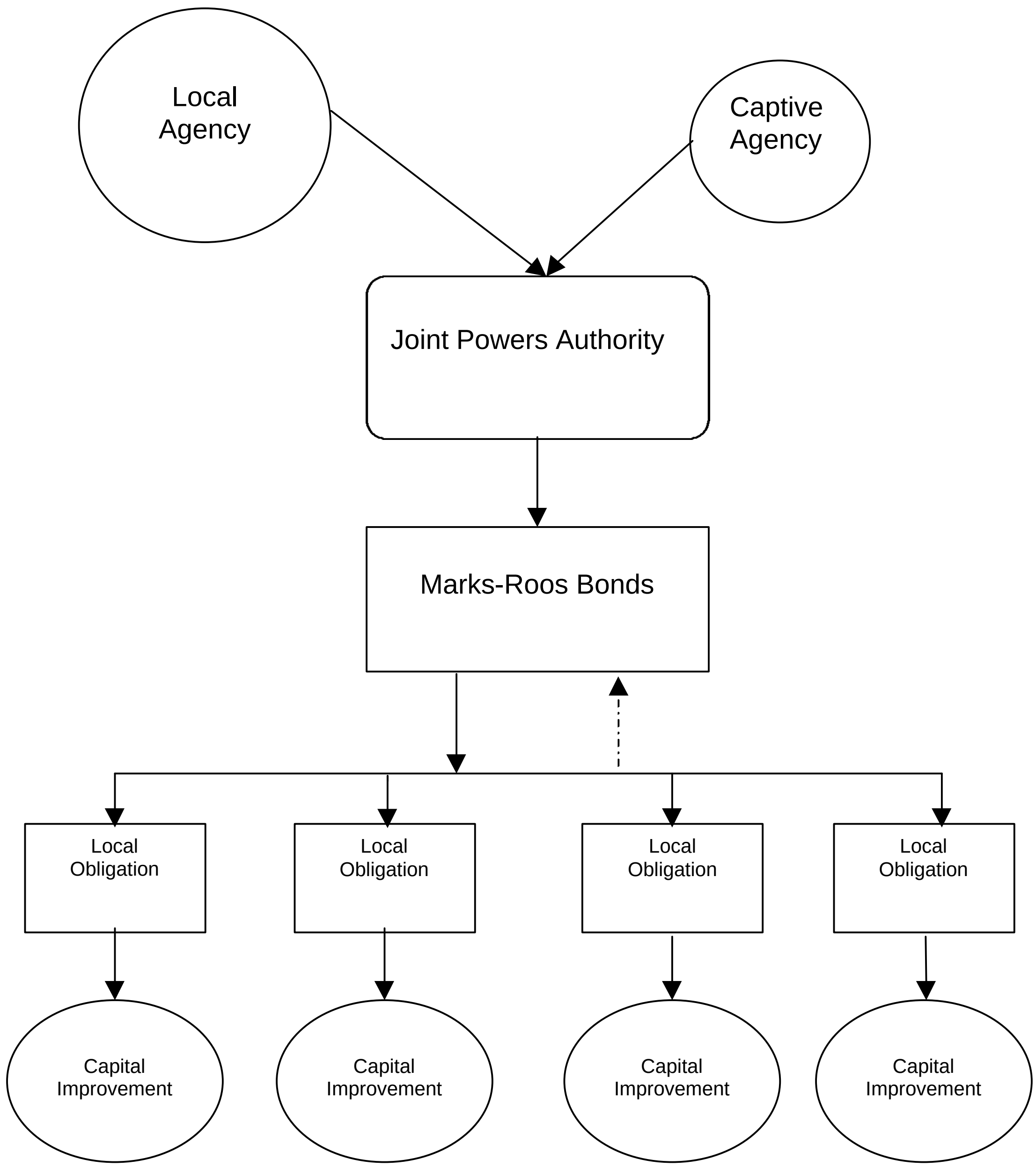


Figure 2

Captive JPA – Pooled Project Financing

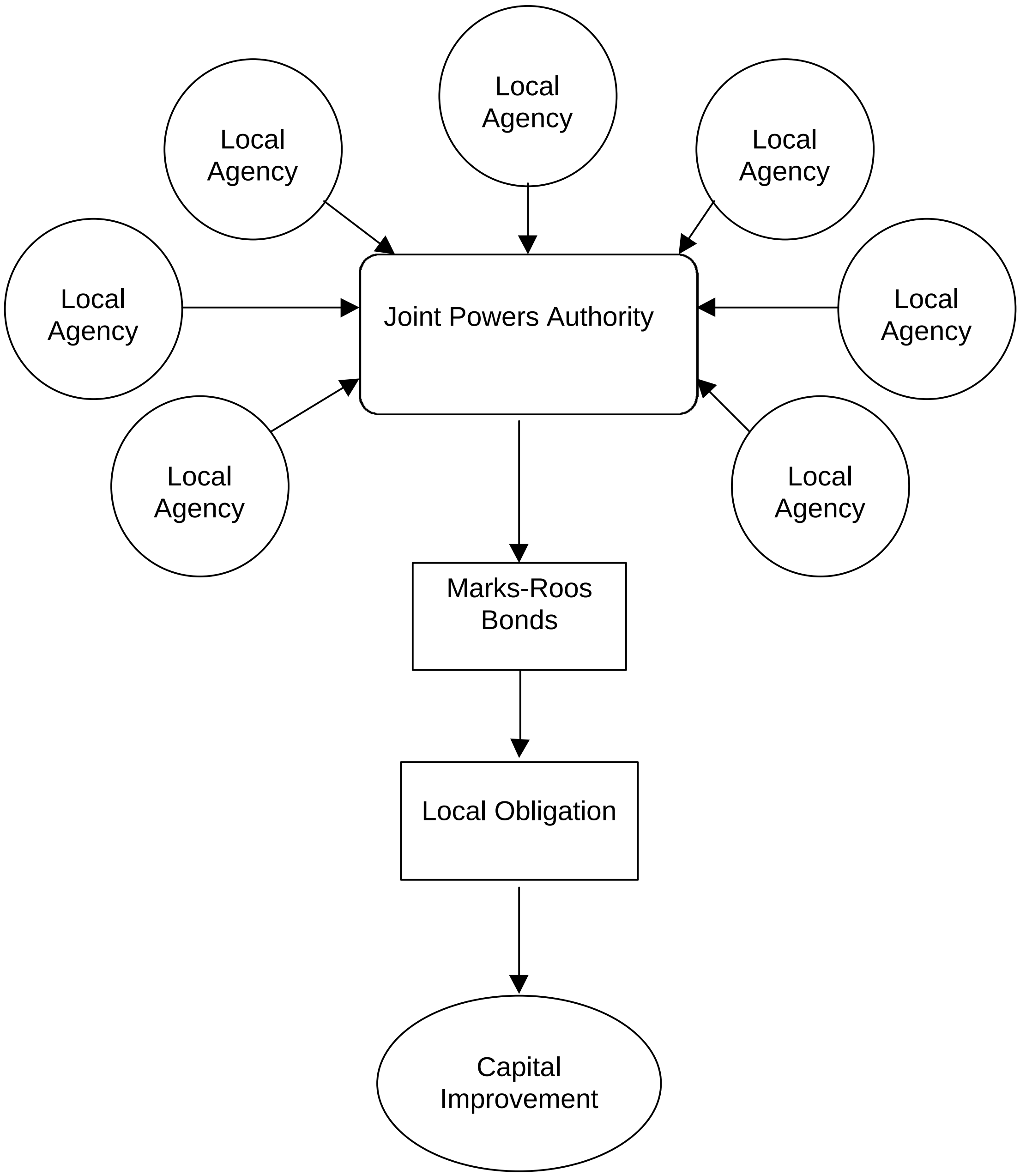


- ***Multijurisdictional JPA – Single Project Financing.*** Figure 3 on page 41 depicts a *Multijurisdictional JPA – Single Project Financing*. This structure accounts for one-fifth ($5 billion) of the bond issuance under the Marks-Roos Act between 1987 and 1997. The most common example of this type is that of the multijurisdictional or "traditional" JPA financing a regional project, such as a water supply or power system, under the Marks-Roos Act instead of the less flexible revenue bond provisions of Article 2 of the Joint Exercise of Powers law. This category also represents those statewide or regional JPAs such as the CSCDA or ABAG that function as conduit issuers on behalf of their members for reasons of cost or ease of administration. The advantage of single project financing over pooled financing is responsiveness – a JPA can respond more quickly to its members' financing needs by issuing bonds when a project is "ready to go", as opposed to waiting for several projects to reach a state of readiness so that a pooled offering may be assembled. Of course, a single project financing does not present the opportunity to achieve the issuance cost economies that may be possible under a pooled structure.

Special fund enterprise revenues represent the largest repayment source for Marks-Roos bonds issued by multijurisdictional JPAs for single projects (48 percent), followed by general fund lease revenues (32 percent) and special tax and assessment revenues (11 percent).

Figure 3

Multijurisdictional JPA- Single Project Financing



- ***Multijurisdictional JPA – Pooled Project Financing.*** Figure 4 on page 44 depicts a *Multijurisdictional JPA – Pooled Project Financing*. This category includes the variety of bond pools issued under the Act by statewide and regional JPAs for purposes such as liability insurance, leasing, and redevelopment. ABAG, for example, runs a pooled financing program for redevelopment agencies that combines the refunding of outstanding tax allocation bond issues with money for new projects of the participating agencies, according to their needs. This financing structure accounted for $3.6 billion, or 15 percent, of the total volume of Marks-Roos bond issuance between 1987 and 1997.

  Blind pools secured by investment agreements and unidentified local obligations comprise the largest repayment source for Marks-Roos bonds issued by multijurisdictional JPAs for pooled projects (35 percent). The other categories of repayment were as follows:

  - General Fund Lease Revenues (16 percent)
  - Special Fund Enterprise Revenues (12 percent)
  - Redevelopment Tax Increment Revenues (10 percent)
  - Insurance Premiums (nine percent)
  - General Obligation Bonds (seven percent)
  - Multiple Sources (five percent)
  - Mello-Roos Special Tax and Special Assessment Bonds (five percent), and
  - “Other” Repayment Sources (a category consisting of bond anticipation notes and private deeds of trust, at one percent).

- ***Senior-Subordinate Structure.*** Figure 5 on page 45 depicts the *Senior-Subordinate Structure*, which is an alternative method of issuing bonds for either single or pooled project financing under the Act. It is way of structuring payments from one or more local obligations to improve debt service coverage on a portion of the Marks-Roos debt issued by a JPA so that it may achieve an investment grade credit rating. This structure typically is used in financing programs involving high-yield municipal securities, such as Mello-Roos and special assessment bonds, that ordinarily would be issued without a credit rating.[36]

Under the senior-subordinate structure, the JPA issues two series of bonds – a Series A, which has a senior lien on all revenues of the JPA – and a Series B, which has a subordinate or junior lien on the revenues. The Series A bonds, though secured by a first claim on all revenues of the JPA, are issued in an amount less than the principal amount of the underlying local obligations to build in extra debt service coverage. The debt service coverage on the Series A bonds can be increased by decreasing the size of the Series A bonds relative to the Series B bonds. The extra coverage allows the JPA to issue the Series A bonds with an investment grade credit rating (usually with insurance) and then issue the Series B bonds without a credit rating. This should result in a lower "blended" cost of funds to the JPA than if it simply issued a single unrated bond issue.

[36] The reason that certain bonds are unrated has more to do with market perceptions than cost. Bonds that would not qualify for an investment grade credit are easier to market without a credit rating than with a noninvestment grade credit rating. As a consequence, issuers rarely choose to pay for noninvestment grade credit ratings.

Figure 4

Multijurisdictional JPA – Pooled Project Financing

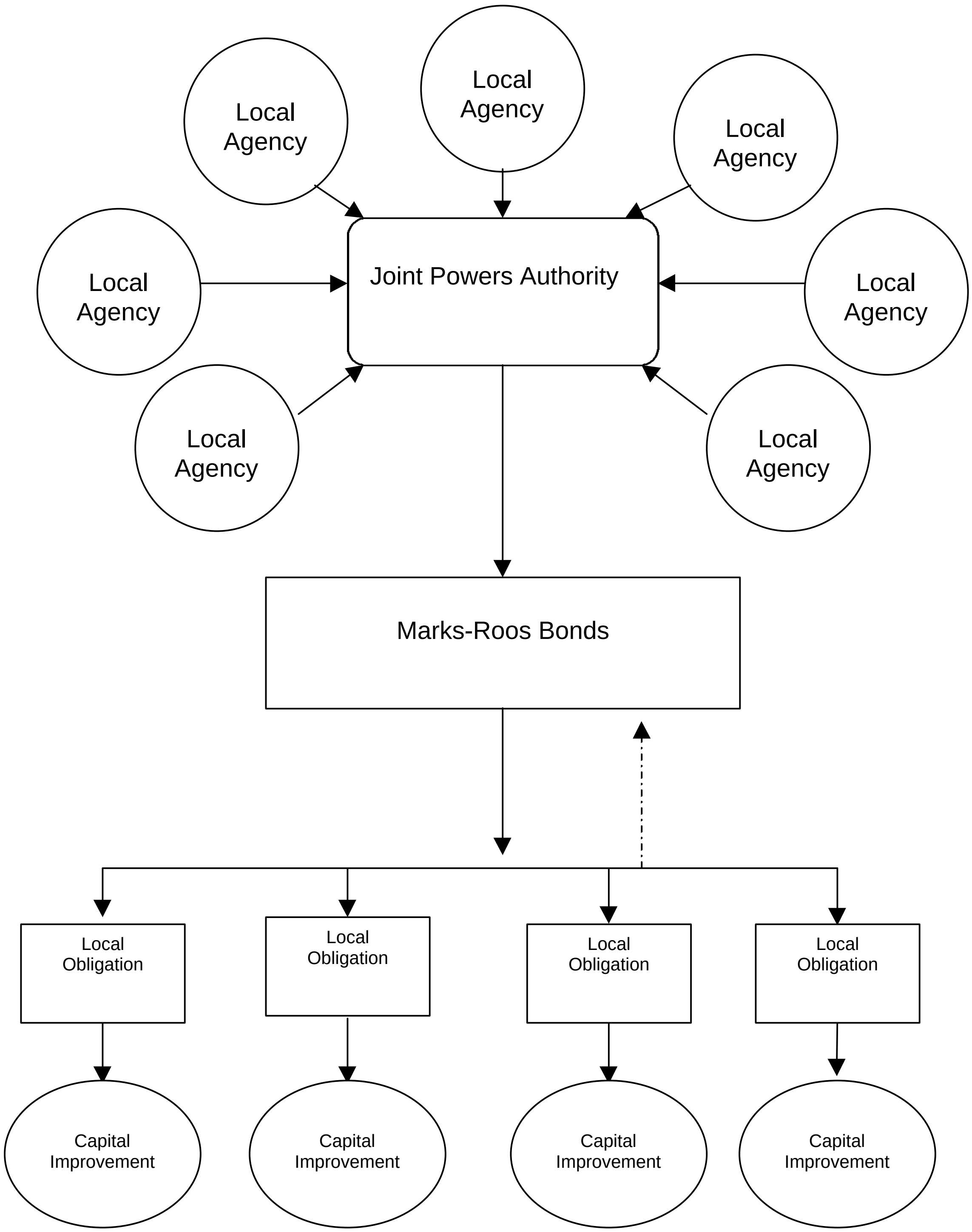
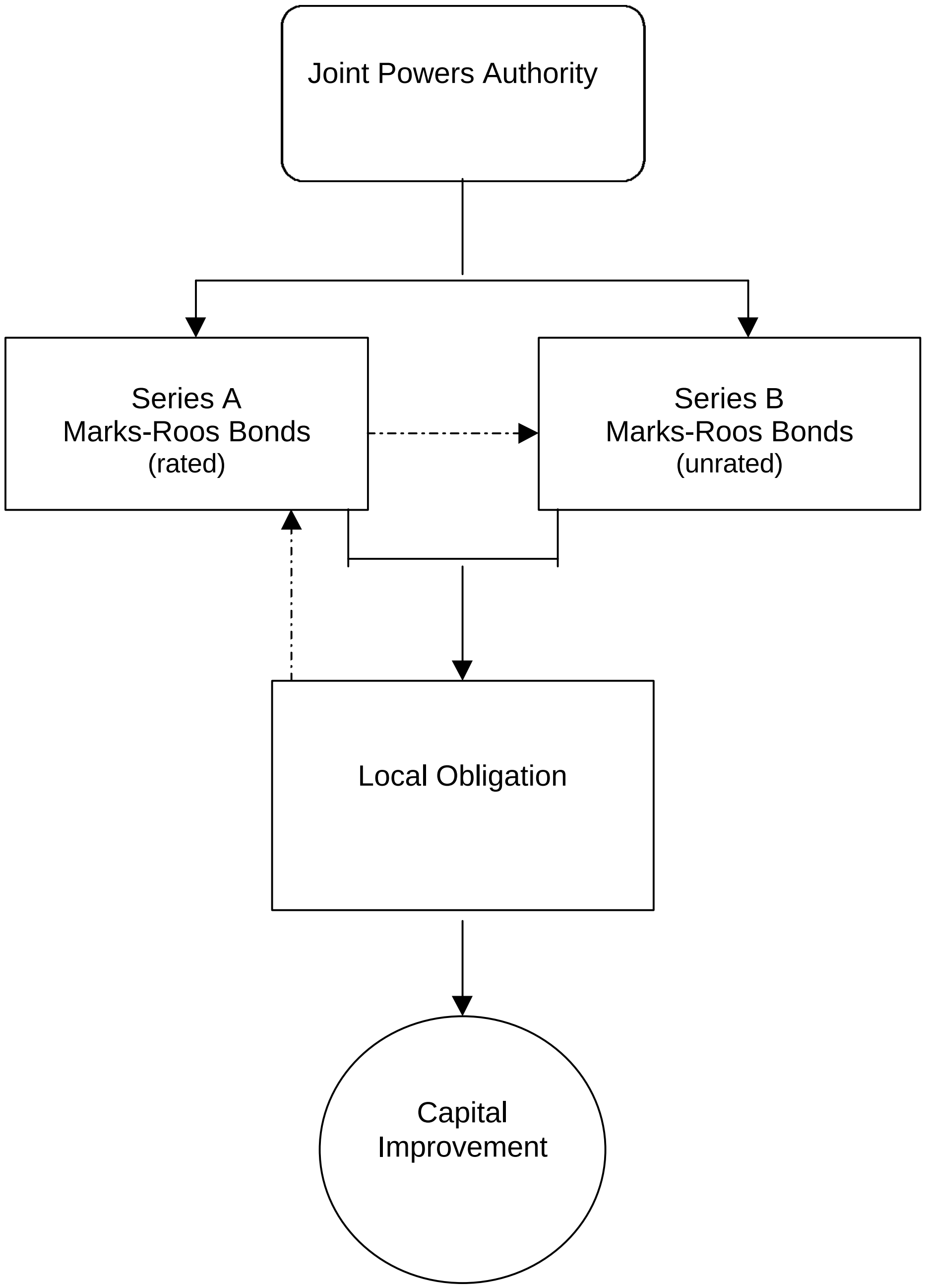


Figure 5

Senior – Subordinate Structure



Costs of Issuance

The Marks-Roos legislation was enacted in large part to provide local agencies with the opportunity to achieve issuance cost economies through bond pooling.[37] Such economies in theory are attributable to two factors. First, by spreading the fixed issuance costs over a larger dollar volume of debt issuance, the cost per dollar of bonds issued is reduced. Fixed issuance costs, which do not vary according to the size of a bond issue, are typically a small portion of total issuance costs, and include such items as printing, advertising and fees to governmental and professional organizations. Bond pooling allows these costs to be shared by several agencies or among multiple projects of a single agency. Second, while issuance costs for professional services tend to increase with the size of a bond issue, they do not increase proportionately. These costs account for the bulk of issuance costs, so small changes in their proportion can produce significant savings. However, there are limits to what can be achieved. An investment banking firm will not underwrite a bond issue if it can not cover its costs and earn a reasonable profit. The same incentive applies to bond counsel, financial advisors and any other professionals that might assist on a bond offering. In other words, there is a certain amount of overhead involved in accessing the municipal bond market, and this can make relatively small bond issues uneconomical.

The theoretical appeal of bond pooling notwithstanding, the financial press has reported through the years that the costs of issuance for certain Marks-Roos bond offerings – and in particular, the underwriter's discount – were as much as ten times the industry average. As part of this data review, CDIAC staff conducted a detailed statistical examination of issuance costs for Marks-Roos bond issues, to determine the extent to which pooling has resulted in savings.

Methodological Approach

The hypothesis that bond pooling results in issuance cost savings of course is only relevant to those bonds issued under the Act for bond pooling purposes. The cost of

[37] Costs of issuance include underwriting, legal, financial advisory, consulting and credit enhancement fees, along with printing costs and other miscellaneous expenses.

issuance analysis below therefore maintained the *pooled* and *single project* distinction for Marks-Roos bonds developed earlier in this chapter. Issuance costs for single project Marks-Roos bonds were not expected to differ from non Marks-Roos bonds, and were evaluated to verify this assumption.

Ideally, this analysis would have compared the costs of issuance for each pooled Marks-Roos bond issue to an estimate of the cumulative costs of issuance that would have been incurred had each project in the pool been financed separately. This approach would have directly tested the hypothesis that bond pooling results in issuance cost savings. Unfortunately, attempting to separate the multiple capital improvements funded through a pooled Marks-Roos bond issue into discrete "projects" for the purpose of analysis, and adjusting for differences in credit risk and other factors, would have been a prohibitively time-consuming task, subject to a considerable margin of error. As a more feasible alternative, CDIAC staff compared the costs of issuance for pooled Marks-Roos bond issues to the costs for other types of bond issues of the same general size. For this purpose, CDAIC staff selected a random sample of long-term bonds not issued under the Marks-Roos Act.[38]

By comparing the issuance costs for Marks-Roos bond issues to non Marks-Roos bond issues of the same size, however, this analysis understates the cost savings that were achieved through pooling. This is because the alternative to issuing a pooled Marks-Roos bond issue is not to issue a similarly sized bond issue under separate statutory authority, but instead to issue a series of smaller bond issues under separate statutory authority. The aggregated costs of issuance for the smaller bond issues would be higher than the issuance costs for the non Marks-Roos bond issue. Suppose, for example, that a $10 million pooled Marks-Roos bond issue funded five separate projects. Ideally, the cost of issuance for this bond issue would have been compared to an estimate of the cumulative costs of issuance for five separate $2 million bond issues with similar characteristics. Due to the data limitations discussed above, however, this analysis compares the issuance costs for the $10 million Marks-Roos bond issue to the issuance costs for a $10 million bond issue issued under a different bond act. In this example, the

[38] Generally speaking, the random sample met the necessary criteria for the use of statistical tests to determine whether a significant difference in the cost of issuance existed between the two methods of issuing debt.

cost savings achieved by pooling the five projects in a Marks-Roos bond issue is understated, because the issuance costs for the $10 million non Marks-Roos bond issue are lower than the aggregated issuance costs for the five $2 million bond issues.

The cost of issuance analysis was confined to the years 1992 through 1996 to be more indicative of current market trends. The bond data, in addition to being divided into pooled and single project categories, were separated by year, to control for declining underwriting spreads during the review period. Thus, Marks-Roos bonds sold in 1992 were compared to non Marks-Roos bonds sold in 1992, and so on through 1996.

The analysis also controlled for the size of the bond issue, since the cost of issuance as a percentage of a bond issue generally declines as the size of the issue grows, for the reasons discussed above. The data was grouped into decile ranges for the purpose of this analysis.

The last methodological issue concerned the presence of “outliers” in the data. Outliers are bonds with costs of issuance percentages that are significantly higher or lower than the costs of issuance percentages for all similar bonds.[39] Most of the outliers identified in the cost of issuance data lay *above* the average cost of issuance and influenced the overall results. Because of this influence, two views of the data are provided below. The first view includes the outliers and describes the results of the statistical tests. The second view removes the outliers from the analysis, which shows their significant impact on the overall data.

Costs of Issuance Comparisons (Outliers Included)

The results of our analysis of the data (including the outliers) were mixed. Pooled bonds had lower issuance costs on average in three of the years examined, but were higher in two years. In 1992, 1994, and 1995, pooled bond costs of issuance were lower than non Marks-Roos bond issuance costs by at least 0.2 percentage points. For example, in

[39] CDIAC staff incorporated a commonly used statistical definition of outlier; that is, data that lie more than two standard deviations away from the average cost of issuance (or underwriter discount) percentage for the year that that bond was sold. By establishing a two-standard deviation spread, 95 percent of the data falling within the central portion of a normal distribution would be analyzed.

1992, the average annual pooled bond costs of issuance was 2.8 percent compared to 3.0 percent for non Marks-Roos bonds. In 1993 and 1996, however, pooled bond issuance costs exceeded non Marks-Roos by a similar amount. As expected, the cost of issuance did not differ markedly between single project Marks-Roos bonds and non Marks-Roos bonds. In certain years the single project bonds had higher issuance costs than the non Marks-Roos bonds while in other years, they had lower issuance costs, with no discernible pattern to these differences.

Although the direct issuance cost comparison indicates a lower cost for pooled issues, the statistical tests indicate that the difference is not significant. This result is not unusual given the nature of the comparison being made, which is a proxy for the ideal analysis, and the presence of outliers in the data.

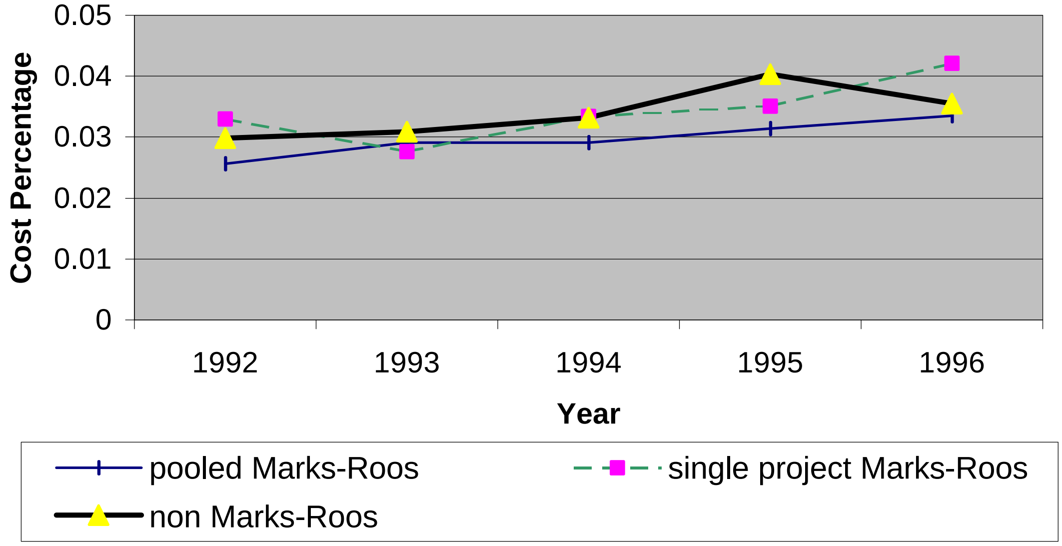
When the underwriter's discount was examined separately from total issuance costs, the data also did not show statistically significant differences between the three categories of bonds.

Costs of Issuance Comparisons (Outliers Excluded)

The inclusion of outliers in the above analysis had a considerable effect on the results. Chart 7 shows costs of issuance comparisons after outliers were removed. When outliers are omitted from the analysis, pooled bond costs of issuance for all years were lower than non Marks-Roos bond issuance costs. The pooled bond costs of issuance dropped across all years by up to nearly half a percentage point. For example, in 1993 the average annual pooled bond issuance costs dropped from 3.3 percent to 2.9 percent when three bond outliers were omitted.[40]

[40] These outliers had issuance costs ranging from nine percent to 11.5 percent of the amount sold and accounted for approximately $32 million in bonds sold.

Chart 7
Costs of Issuance Comparison with Outliers Removed



Of the above-average Marks-Roos bond outliers removed from Chart 7, 16 were single project bond issues (totaling $61 million) and nine were pooled bond issues (totaling $84 million). The percentage costs of issuance ranged from six percent to almost 15 percent for the pooled bond issue outliers and from six percent to over 15 percent for the single project bond issue outliers. The costs of issuance for these bond issues generally were between two and five times as high as the average cost of issuance for the remaining data in each year. (One large bond issue, totaling $219 million, had a below average cost of issuance of one percent.)

Removing the outliers from the underwriter's discount data reduced the overall average underwriter discount costs of both pooled Marks-Roos bonds and single project Marks-Roos bonds, in some years by up to 0.2 percentage points.[41] For example, the average underwriter discount costs for pooled bonds in 1996 dropped from 1.6 percent to 1.4 percent. With these outliers removed from the data, the underwriter discounts are virtually the same for all three methods of bond issuance.

The statistical tests again indicate that these cost differences are not significant. The results generally show that issuance costs for pooled Marks-Roos bond issues do not differ statistically speaking from issuance costs for non Marks-Roos bond issues. Again, these results are conservative, erring on the side of underestimating the savings associated with pooling bonds.

With respect to single project bond issues, removing the outliers reduced the average issuance costs for the Marks-Roos issues by up to 0.4 percentage points. As Chart 7 shows, though, the difference in costs of issuance between single project bonds and non Marks-Roos bonds is not readily discernible and still varies from year to year. The statistical tests confirm these results–that is, there is no statistically significant difference between these two methods of issuance.

Interpreting the Results

Given the data limitations of this analysis, the overall results provide some evidence that bond pooling results in issuance cost economies. This premise would have been called into question had the issuance costs for pooled Marks-Roos bond issues been considerably higher than the costs for the non Marks-Roos bond issues. If some unknown factor were driving up the issuance costs for Marks-Roos bond pools, then it would not necessarily be the case that consolidating the financing of several capital projects in a bond pool would result in issuance cost economies. The fact that issuance costs for the pooled Marks-Roos bond issues in this study were comparable to (and in

[41] Nine pooled underwriter discount outliers were identified – eight bond issues (totaling $87 million) with above average costs ranging from three percent to seven percent, and one bond issues (totaling $220 million) with below average costs of nearly one percent. Fifteen single project bond outliers (totaling over $75 million) were identified. These issues have above average underwriter discount costs ranging from nearly three percent to eight percent.

some instances lower than) the costs for non Marks-Roos issues thus provided indirect evidence that bond pooling saves money. More precisely, the results did nothing to disturb the conventional notion that economies may be achieved by distributing the fixed cost of issuance among several projects.

If the ideal comparison were made, the results likely would show that the issuance costs for pooled bond issues were significantly lower than the cumulative issuance costs incurred in undertaking separate bond issues for separate capital projects. Such savings would be attributable to the sharing of fixed issuance costs, through, for example, the use of standardized loan agreements, which obviate the need (and expense) of drafting specific stand-alone documents for each borrower.

As expected, the data analysis did not produce evidence of a statistical difference between single project Marks-Roos bonds and non Marks-Roos bonds, though the outliers increased the average issuance costs for the Marks-Roos issues.

Lest we forget, the outliers are not merely data points but represent real bond issues. As such, the outliers not only pose problems for statistical analysis but also raise important policy questions concerning the level of oversight that issuers exercise over Marks-Roos financings. The following chapter addresses this and other key policy issues.

Summary

The broad financing powers authorized by the Marks-Roos Act may be used to pool the financing of several capital project into a single bond issue, as the full title of the Act suggests, or as an alternative method of financing single capital projects. CDIAC staff reviewed official statements for 874 Marks-Roos bond issues sold between 1987 and 1997, totaling $24.4 billion, to capture information on the sources and uses of funds for each issue. This review indicated that roughly one-half of this amount ($12.3 billion) was issued for pooling purposes and the other half ($12.1 billion) was issued to finance single capital projects. In the short-term market, the volume of pooled tax and revenue anticipation notes (TRANs) has averaged over $1.5 billion annually since 1994.

The Marks-Roos Act differs from other municipal bond laws in that it does not specify a tax, fee, or other revenue source to be pledged as security for bonds issued under the Act. Instead, the Act provides an alternative method of issuing bonds secured by revenues that a local agency derives under separate statutory authority. The data indicate that about one-half of bonds issued under the Marks-Roos Act are secured by general fund lease and special fund enterprise revenues, obligations that most likely would be issued as COPs in the absence of the Marks-Roos Act. The Marks-Roos Act enables issuers to substitute “bonds for COPs” and achieve more favorable terms with investors. Another twenty percent of the Marks-Roos bond issues included in the data review were secured by the tax increment revenues of redevelopment agencies, who otherwise must issue debt under more restrictive provisions of law. All of the remaining repayment sources collectively account for less than 30 percent of the volume of Marks-Roos issuance.

The relative importance of the various sources of repayment for Marks-Roos bonds differ between single project and pooled financings. In general, the sources are more varied for pooled Marks-Roos bond issues, which suggests that pooling economies may be achieved in a number of different sectors of the public finance market. The sources of repayment for single project issues are concentrated in special fund enterprise revenues, general fund lease revenues, and redevelopment tax increment revenues, for the reasons discussed above.

The analysis of issuance costs under the Marks-Roos Act conducted by CDIAC produced some evidence that bond pooling results in issuance cost savings, although these results were not statistically significant. This analysis, however, understated the benefits of bond pooling, because it was not possible to derive an estimate of the cumulative issuance costs that would have been incurred had each pooled project been financed separately. Had it been possible to formulate an ideal statistical test, it is likely that the issuance cost savings derived from bond pooling would have been greater. The analysis found no statistically significant difference in the cost of issuance between single project Marks-Roos bonds and non Marks-Roos bonds.

CHAPTER III

PUBLIC POLICY ISSUES

Flexibility is the hallmark of the Marks-Roos Act. By simply passing a resolution, a JPA may issue bonds under the Act to finance almost any kind of public capital improvement from almost any local agency revenue source. As a separate entity from the local agency borrower, a JPA may combine and package local agency revenue sources as security for a bond issue in ways that a local agency could not do acting by itself. The intermediary role of the JPA facilitates various bond pooling arrangements – for new capital projects and refundings, in the long-term and short-term markets – and allows structured finance techniques pioneered in the corporate securities market to be applied in municipal securities offerings. The Marks-Roos Act also facilitates the issuance of bonds for single projects by streamlining the issuance process – procedural requirements and other restrictions that would otherwise apply to single local agency financings are not applicable under the Marks-Roos Act.

Still, the ideal of maximum flexibility in local government debt issuance is at odds with the philosophy that public borrowing must be carefully controlled, a philosophy that historically has guided the development of California's constitutional and statutory provisions regarding indebtedness. The various debt restrictions imposed by the state Constitution and the organic bond laws of the state-referendum requirements, restrictions on the method of sale, maturity structure, and amount of indebtedness – were intended to curb excessive borrowing and promote accountability for the borrowing decision. The Marks-Roos Act essentially outflanks these restrictions through its construction as a "complete and supplemental method of borrowing." In other words, the Act supercedes other bond laws. And while no bond law can authorize a local agency to circumvent the constitutional debt limit, the Marks-Roos Act certainly facilitates the use of lease and installment sale financing structures that rely on judicially created exceptions to that limit.

Thus, the Marks-Roos Act poses something of a quandary for policy-makers. Its very presence calls into question the rationale for many statutory restrictions on the issuance of debt. Yet the state has a responsibility to ensure the stability of its public capital markets, and its response to past abuses has been to “tighten up” the Marks-Roos Act by imposing restrictions on its use. Is this the appropriate response to the abuses that continue to bedevil the Marks-Roos Act, or can such problems be effectively controlled in another manner? This chapter of the report examines these and other policy issues that should be considered by the Legislature in evaluating the Marks-Roos Act.

Is a Major Reform of the Marks-Roos Act Needed?

The flexibility in issuance afforded by the Marks-Roos Act may be justified on the grounds that many restrictions on public indebtedness have become anachronistic, or that they have only very limited applicability given the financing structures in use today. In the absence of evidence of local agencies exposing themselves to needless risk and financial chaos, it may be argued that there is no compelling reason for the state to maintain a paternalistic approach in this area. Certainly, the relative stability of today’s municipal bond market is attributable less to constraints on indebtedness than to a host of unrelated factors. These include the evolution of public financial management and reporting practices; the enactment of securities laws and regulations; the refinement of credit analysis techniques; and the success of federal monetary policy. In fact, the adoption of the Marks-Roos Act may be seen as a rejection of the prior philosophy by the Legislature, and the maintenance of those prior restrictions elsewhere in the law as evidence of a defect in the legislative process. It simply is difficult to build consensus for reforms that are susceptible to being portrayed as irresponsible.

Arguments in favor of the flexibility in issuance afforded by the Marks-Roos Act can be buttressed by reference to hundreds of legitimate financings which have generated savings in time, money and effort for local agencies. However, these arguments must also be reconciled with the Act’s troubled history. The Marks-Roos Act has achieved a certain infamy among securities regulators and the financial press as the result of a series of abusive transactions conducted under its auspices over the past decade. The fact that most of these abusive bond deals can be traced to a few bad actors has not muted criticism of the Act itself. Due to its breadth and complexity, the Marks-Roos Act may inadvertently create the climate for abuse, as issuers, regulators and the bond market in general do not share a common conception of what the Act does and does not permit.

The Marks-Roos Act established a new, purely financial role for JPAs that contrasts with the traditional role of JPAs as vehicles for the joint exercise of common powers by local agencies. In its historical context, the term *joint powers authority* connotes shared decision-making and mutual obligation. But as we have seen, most JPAs that issue Marks-Roos bonds were established to issue bonds on behalf of a single local agency. These transactions do not involve any joint exercise of powers common to two or more public agencies. Rather, they shift decision-making authority to another entity – a JPA – and this makes it more difficult for the public to determine who is accountable for financings conducted under the Act. In fact, the Official Statements for Marks-Roos bond issues state in capital letters that the local agency sponsors are in no way responsible for the bonds that the JPA has caused to be sold. The Act also led to a proliferation of JPAs throughout California, further fragmenting the state's already confounding system of governance.

Flexibility and accountability in public debt issuance are both desirable goals. Flexibility allows public agencies structure their debt in ways that can both take advantage of technical innovations and accommodate unique situations. Accountability encourages public agencies to make responsible use of their debt issuance authority, because irresponsible use may result in adverse legal, financial, and political consequences. But would reforms that reduced flexibility in debt issuance automatically produce more responsible use? We think not. The Marks-Roos Act is an *alternative method* of borrowing, and confers no other powers, such as the ability to access new sources of revenue. Thus, if the flexibility in issuance provided by the Act were to be sacrificed in the name of reform, local agencies would revert to other existing financing tools. Projects normally financed through Marks-Roos bonds instead could be financed through COPs, tax allocation and Mello-Roos bonds, and revenue bonds of various sorts. Shifting the composition of local borrowing toward these borrowing techniques could cost local agencies additional money, and make some transactions difficult or impossible. But the transactions would still be no less likely than Marks-Roos transactions to be structured in irresponsible ways. The potential for abuse is not limited to the Marks-Roos Act, and is mitigated only by the diligence of public officials and their professional consultants.

To eliminate the potential for abusive local borrowing practices, some have argued that the Legislature should adopt a broad package of public finance reforms. This might take the form of greater voter approval requirements for all forms of debt issuance, or tighter limits on outstanding debt of all types. In recent years, certain legislators and taxpayer groups have endorsed constitutional amendments to impose voter approval requirements on all forms of municipal obligations, including Marks-Roos bonds, COPs and tax allocation bonds. The failure of these proposals suggests that the principle of subjecting bond measures to mandatory referendum does not generate the same passion as the by now well-established principle of subjecting tax and fee increases to referendum. Rather, bond proposals tend to become controversial only when the project itself is unpopular, and the municipal bond laws in turn become controversial as a result of their role in financing unpopular projects.

Raising Taxes vs. Leveraging Revenues

Although the Marks-Roos Act itself imposes minimal procedural requirements on the issuance of bonds, the constitutional and statutory restrictions on taxation imposed by voter-approved initiatives over the years already act as an indirect constraint on the issuance of Marks-Roos bonds. Realistically, a JPA may issue bonds under the Act only if one or more local agencies pledge to repay the debt. If a local agency needs to raise taxes or fees to support debt service, in most instances state law now requires voter approval of the measure. Voter approval of the tax or fee increase needed to support a bond offering is tantamount to voter approval of the bond issue itself, and serves to neutralize concerns about the legitimacy of the bond issue. Of the various repayment sources that are pledged to the repayment of Marks-Roos bonds, those that require voter approval include public enterprise fee increases, Mello-Roos special taxes and special assessments, and general obligation bonds.[42] If no tax or fee increase is required to pay debt service on a Marks-Roos bond issue, then no voter approval

[42] Until the voter approval requirement imposed by Proposition 218 in 1996, fees could be raised without voter approval. Similarly, special assessments did not require voter approval prior to the approval of Proposition 218, though assessments were subject to “majority protest” provisions of law. Additionally, Mello-Roos special taxes usually are authorized by real estate developers through a “landowner vote” prior to development.

requirement indirectly impedes the issuance of Marks-Roos bonds. Local officials thus enjoy more discretion over bond issues that leverage ongoing revenues. Revenue sources that may be pledged to the repayment of Marks-Roos bonds without voter approval include general fund lease revenues, redevelopment tax increment revenues and ongoing public enterprise revenues (if no fee increase is required).

The issuance of bonds supported by ongoing revenues essentially is a budgeting decision to shift money from an agency's operating budget to its capital budget. Such decisions traditionally have been the prerogative of local elected officials, who are responsible to their constituents for delivering the highest level of public services possible within their budget constraints. CDIAC does not see a statewide interest that would be advanced by restricting the autonomy of local elected officials over the issuance of bonds that do not require tax or fee increases.

To summarize this discussion, then, there appears to be little to be gained by attempting a major reform of the Marks-Roos Act. Used responsibly, it provides a valuable tool for local officials in carrying out their capital budgeting and debt management duties. Accepting the basic statutory framework of the Marks-Roos Act, however, does not represent a retreat from the goal of promoting accountability and responsibility in its use. The Marks-Roos Act *already* has been amended in recent years – repeatedly – to curb the imposition of excessive fees, to restrict blind pools, and to outlaw roving JPAs. The fact that each of these problems has persisted in some form indicates a deficiency in enforcement of the law, rather than a flawed statute. Improving the enforcement of municipal bond laws is of course an issue that concerns more than the Marks-Roos Act, and is discussed in more detail at the end of this chapter.

Role of Local Debt Management Policies

Ultimately, local agencies must bear the responsibility for their use of the state's bond laws. To that end, local agencies should have in place debt management policies that specify the purposes for which they will issue various types of municipal obligations and the standards of creditworthiness to which they will adhere. The debt policy complements an agency's capital budget and provides its legislative body with a tool to make informed borrowing decisions. Ideally, local debt management policies promote the goal of accountability by demonstrating that an agency has in place a coherent plan for addressing its capital spending needs within its means.

Incorporating criteria for the use of Marks-Roos financing into a local debt management policy is complicated by the diverse financing activity authorized by the Act. In light of this diversity, it makes sense to evaluate the Marks-Roos financing as one option for financing the range of programs and projects authorized under the Act, a list which includes short-term cash flow borrowing, liability insurance, and a wide variety of public capital improvements. The key consideration is to ensure that the debt burden of the general fund and the various special funds that may secure a Marks-Roos bond issue remains within reasonable parameters. The question of whether an agency's debt should take the form of Marks-Roos bonds, COPs, or other debt instruments is secondary to the analysis of debt affordability. Debt policies should provide local agencies with the flexibility to finance their project and programs in the most cost-effective manner.[43]

The debt management plan also may specify criteria for subjecting to referendum bond proposals that do not require voter approval under law. In this regard, local agencies can look to the City of San Diego for guidance. In the aftermath of the controversy over its Civic Center Expansion, which was preceded by a similar spat over the renovation of Jack Murphy (now Qualcomm) Stadium, the Mayor established a Task Force on Voter's Rights. The main recommendation of the Task Force was that the city charter be amended to require voter approval for public building projects that have a construction cost equal to nine percent or more of the city's general fund (which would translate to projects costing $49 million or more this year). While such criteria can be tailored to local circumstances, the point of voluntarily subjecting bond proposals to referendum is to gauge community support for controversial projects. As noted earlier, when local agencies attempt to issue debt for unpopular projects, it is not only the unpopular project that comes under fire, but the bond law as well. The flexibility that local agencies enjoy under current law to issue bonds without voter approval is sustainable in the long run only through responsible use.

[43] The Government Finance Officers Association (GFOA) has more detailed information on developing debt management policies available on its website (www.gfoa.org/resrch/recprac).

Judicial Review

Local agencies should be aware that the validity of their proposed bond issues may be challenged by any interested person under the judicial review procedure provided for in state law.[44] Such a challenge is most likely to occur in the case of a controversial financing proposal (in fact, the *Rider v. City of San Diego* case recently decided by the California Supreme Court started out as a validation action in Superior Court). Defending the validity of a proposed bond offering in court can be a lengthy and expensive proposition for an issuer. Thus, an issuer's efforts to solicit public input on a controversial bond proposal, through an advisory vote or other means, may dissuade persons from challenging the bond offering in court.

CDIAC advises local agencies themselves to consider validating any proposed bond offering that relies on a novel interpretation of the Marks-Roos Act (or any other state bond law, for that matter) under this procedure.[45] For an issuer to undertake a validation action, it files a lawsuit naming "all interested persons" as defendants. Notice of the lawsuit is given by publication in the newspaper and by posting public notices. If no interested person comes forward to challenge the financing, the issuer may ask the court for a judgment declaring that the financing is valid. This process takes about 45 days. Once the court issues a validation judgment, and the 30-day appeal period expires, the financing cannot later be challenged in court. However, if an interested person does challenge the financing in a timely manner, the process can take much longer.

Private Development Finance

There are limits to the flexibility of the Marks-Roos Act. The Act basically authorizes JPAs to assist *local agencies* in financing *public capital improvements*, though it provides many means to this end. In land-based municipal finance, the Act often has been used to pool Mello-Roos and assessment bonds issued to finance necessary public infrastructure such as streets, sewers, schools and parks. Technically, the JPA must purchase bonds issued by Mello-Roos CFDs or assessment districts rather than loan money directly to these districts, because the districts do not have the authority to

[44] California Code of Civil Procedure Section 863.
[45] California Code of Civil Procedure Section 860 et seq.

borrow money apart from their bond issuing powers. Thus, the local obligations purchased by the JPA must adhere to the credit standards and procedural requirements specified in the Mello-Roos or assessment act, which protect both local agencies and investors from potential abuse.

Certain recent Marks-Roos transactions, dubbed *roving JPA* bond issues in the financial press, have raised concerns about the extent to which the Marks-Roos Act may be used as a tool of private real estate development finance. In the roving JPA structure, the JPA does not acquire Mello-Roos or assessment bonds, but instead loans bond proceeds to a real estate developer ostensibly for the financing of public capital improvements. The issuance of Marks-Roos bonds for private development purposes, unfettered by the credit standards and procedural requirements imposed by the Mello-Roos or assessment acts, has exposed investors to unprecedented levels of credit risk for the municipal bond market. Although recently enacted legislation has outlawed roving JPAs (effective January 1, 1999), there will continue to be an economic incentive to use the Marks-Roos Act for private development purposes – the municipal bond market is an attractive source of low cost, off-balance sheet financing. The financing structures employed by the roving JPA bond issues – the uses of bond proceeds and the sources of repayment – therefore deserve close scrutiny.

Municipal bond offerings must comply not only with their organic borrowing laws but also with federal and state securities and tax laws. In general, the securities laws require the full disclosure of material information to investors, and the tax laws limit the use of tax-exempt debt instruments to public purposes, with exceptions for qualified private activity bonds. If the purpose of a municipal bond issue is to provide loans to real estate developers, the bonds would be classified as *private activity* bonds by the Internal Revenue Service and be subject to federal and state income taxation. Misrepresenting the purpose of the bond issue in disclosure documents prepared for the offering would constitute a violation of the antifraud provisions of the federal and state securities laws, and subject the persons responsible for the disclosure to civil and criminal liabilities. The developer's obligation to repay the bonds, moreover, could be classified as a "separate security" by the U.S. Securities and Exchange Commission and be subject to the registration provisions of the Securities Act of 1933.

The official statements prepared for the roving JPA bond issues typically identify a legitimate public purpose for the borrowing, often the acquisition of open space.[46] The veracity of the disclosed purpose of the roving JPA bond issues is called into question, however, by the security pledged to the repayment of the bonds. The official statements for these bond issues typically state that developer “site revenues” (i.e., revenues derived from improved lot sales) are pledged to the repayment of the bonds. This is the same type of security that is pledged for commercial real estate development loans, and is quite unusual for a municipal bond transaction. Normally in land-based municipal finance, bonds are secured by special tax or assessment liens on property and are not personal obligations of the developer. Yet the development agreements prepared in conjunction with several of the roving JPA bond issues reportedly indicate that the developer is personally responsible for repayment of the bonds. It is hard to fathom why a real estate developer would pledge its site revenues and assume a personal obligation to repay a bond issue if the bonds were not in fact development loans. If the developer was simply being compensated for the fair market value of property being sold to a public agency, he or she would not assume any obligation whatsoever for the repayment of the bonds.

The Marks-Roos Act authorizes a JPA to accept money and other forms of compensation from any source for the financing of a public capital improvement, or the payment of principal and interest on bonds, as long as the bonds were issued for a purpose authorized in the Act.[47] Thus, a private revenue source such as developer site revenues could be pledged to the repayment of bonds if the bonds were issued to acquire open space or for another purpose authorized in the Act. But this would not be lawful if the bonds were in reality issued to loan money to a real estate developer for private purposes, which in and of itself is not authorized by the Act.

Under federal tax rules, the pledge of private revenues to the repayment of municipal bonds satisfies the *Private Payment or Security Test*, which is one of the Private Business Tests used by the IRS for determining whether a municipal bond is classified

[46] Open space acquisition qualifies as a public capital improvement under Government Code Section 6546 and therefore is permitted under the Marks-Roos Act.
[47] Government Code Section 6588.

as a private activity bond. If a bond issue also satisfies the *Private Business Use Test*, then it is classified as a private activity bond. The Private Business Use Test is satisfied if more than 10 percent of the proceeds of a bond issue is used for any private business use. If more than 10 percent of a Marks-Roos bond issue is used to provide private real estate loans, consequently, the bond issue would satisfy the Private Business Use Test. Even if this test is not satisfied, under the *Private Loan Test*, an issue nevertheless would be an issue of private activity bonds if the lesser of five percent of the proceeds or $5 million are used to make or finance loans to persons other than governmental units. The use of bond proceeds therefore is pivotal for determining the compliance of the *roving JPA* bond offerings with both the Marks-Roos Act and federal tax rules. In each open space acquisition financed through a *roving JPA* bond issue thus far, the issuer has not established an independent measure of the value of the land to be acquired with the proceeds of the bond issue.[48] The subject property has not been appraised, and the descriptions of the property disclosed to investors indicate that it is of little value - for example, the land is located in a flood plain or on the side of a canyon. The land is not fit for development and is therefore of little value to the developer. The fact that the open space is being acquired for *ultimate conveyance* to an unspecified local agency means that no local agency is expending money for the land or is pledging public revenues to the repayment of the debt – raising further doubts as to its value. Moreover, the reason that a local agency would want to acquire open space is to preclude its development – so why would an agency purchase property for this purpose that cannot even be developed – especially at prices comparable to that of developable property?

The roving JPA bond issues disclose that the developers intend to use the money received from the sale or granting of conservation easements on their property for private purposes - to retire encumbrances on property and pay development costs, and for liquidity. The ultimate disposition of the proceeds of these bond issues ordinarily would not be of concern to federal or state regulators – as long as the payments received by the developers were in compensation for the fair market value of assets sold or encumbered. But if the value of the assets sold or encumbered was inflated for the

[48] In certain cases, the developer is not even selling the property, but merely granting a “conservation easement” on it – which presumably is worth less than the fee simple estate.

purpose of deceiving investors as to the purpose of the bond issue, then it matters a great deal. It would indicate that the bonds were not issued for a valid public purpose, but to provide real estate loans for private purposes. This is not a valid purpose for a Marks-Roos bond issue. The bond issue would be classified as private activity bonds under federal tax law and the interest on the bonds would be subject to federal and state income taxation. The developer's obligation to repay the bonds could be classified as a separate security by the SEC and be subject to the registration provisions of the Securities Act. More importantly, the disclosure documents for the bond issues would have misrepresented the purpose of the offerings in violation of the antifraud provisions of the federal and state securities laws. The persons responsible for the disclosures could be subject to civil and criminal penalties.[49]

Inasmuch as bond issues under the Marks-Roos Act are limited to the financing of public capital improvements and certain other public purposes, CDIAC does not believe that the Act needs to be amended to preclude its use for private development purposes. If indeed such unauthorized activity has occurred to date, it was only through misrepresenting the true purpose of bond offerings to investors, in violation of the securities laws. Presumably, the Marks-Roos Act could be amended to make such fraudulent schemes more transparent and difficult to execute, by prohibiting the repayment of bonds from private revenue sources. But such a change to the law would diminish its flexibility, and in the absence of a strong enforcement presence, probably would not deter fraudulent activity. Enforcement of the securities laws is the key to limiting the use of the Marks-Roos Act for private real estate development finance.

[49] In November 1997, the state Department of Corporations filed a lawsuit in Superior Court against Pacific Genesis Group, Inc., two of its principals, two developers and a lawyer involved in the roving JPA bond issues. The suit alleges that the defendants overvalued the land to be acquired as open space as part of a fraudulent scheme to mislead investors. According to the complaint, the economic reality of the security presented to investors was in substance an investment contract issued by the developer. The suit further alleges that defendants violated state securities laws by failing to provide adequate disclosure concerning the developers' plan of finance, lack of experience, disciplinary history, health problems, outstanding monetary judgments, self-dealing and conflict of interest. The firm denies the charges. In January 1998, the Superior Court judge presiding over the lawsuit appointed an independent reviewer to monitor the disclosure and sales practices of Pacific Genesis for an 18 month period. The securities fraud lawsuit is expected to go to trial in late 1998.

Blind Pools

As mentioned in the *Legislative History* chapter of this report, the Legislature enacted SB 1275 in 1995 to severely restrict the issuance of blind pools under the Marks-Roos Act. This action was taken in response to severe financial problems caused by blind pools in several communities throughout the state. SB 1275 requires that all bond proceeds derived from the issuance of bonds under the Marks-Roos Act (Article 4 of the Joint Powers law) be *originated* or loaned out within 90 days of issuance, a period so short as to effectively preclude the issuance of blind pools. Without this provision in state law, the origination period would be limited to three years pursuant to federal tax law.

Since the enactment of SB 1275, the restriction on blind pools under the Marks-Roos Act has been rendered potentially irrelevant by the issuance of blind pools under other provisions of law. Because the Marks-Roos Act had been seen as the only statute authorizing blind bond pooling, the Marks-Roos restriction was thought to amount to a restriction on all blind pools. Also, some market participants have begun to question a policy that effectively bans all blind pools. They have expressed the view that blind pools can provide a cost-effective, low-risk financing option for local agencies, as long as the pool is formed with variable rate securities to mitigate the non-origination risk posed by declining interest rates.

Article 2 Blind Pools

In the past year, a new bond counsel opinion has been issued that supported a blind pool structure issued under Article 2 of the joint powers law, the traditional revenue bond provision of the law. Article 2 does not require the origination of bond proceeds within a 90-day period or explicitly prohibit the issuance of blind pools. In general, however, the power to issue revenue bonds under Article 2 is very limited relative to that provided for by the Marks-Roos Act. The procedural requirements for issuing bonds under Article 2 generally require the identification and local agency approval of projects to be funded in advance of the sale of bonds. Specifically, Government Code Section 6547 specifies that a JPA may issue revenue bonds only upon authorization by the parties to the joint powers agreement. In other words, obtaining this authorization is a *precondition* to the sale of bonds. The authorization must be made by an ordinance subject to referendum, and the ordinance must describe in general terms (1) the project, or projects, to be funded, (2) the maximum amount of bonds to be issued, and (3) the revenue sources which will pay for the redemption of the bonds.

Proponents of the recent blind pools argue that Article 2 allows the issuance of blind pools. According to this view, a two-member JPA can be formed to issue bonds in contemplation of other local agencies joining the JPA and borrowing funds at some point after the sale of bonds. The requirements of Article 2 are satisfied by reference in the ordinance and indenture to a "demand survey" describing a list of potential projects under contemplation by local agencies that are *not* parties to the joint powers agreement. After the bond sale, local agencies wishing to borrow funds from the pool must join the JPA and adopt the same broad ordinance adopted by the original JPA members. It should be noted that under this structure the proceeds of the blind pool bonds ultimately may be used to finance projects not identified in the demand survey, and there is a possibility that a substantial portion of the blind pool may never be originated or loaned out.

At issue in these transactions is whether the proceeds of a bond issued pursuant to Article 2 can be loaned to local agencies which were not a party to the joint powers agreement, and had not adopted the required ordinances, prior to the sale of bonds. State Senator William Craven has requested that the state Attorney General review the validity of blind pool bond issues under Article 2 of the joint powers law, and the Attorney General is expected to issue a formal opinion on this issue during the fall of 1998.

CDIAC is concerned that Article 2 transactions will undermine the reforms and protections incorporated into the Marks-Roos law. Depending upon the outcome of the Attorney General's opinion, legislation may be desirable to clarify the authorization available under Article 2. In addition to the more stringent issuance restrictions under Article 2, federal tax regulations establish specific requirements for blind pools which must be carefully followed in any blind pool financing.

Article 4 90-Day Restriction on Origination of Bond Proceeds. CDIAC has surveyed a number of industry participants regarding the question of whether the 90-day origination period restriction in the Marks-Roos Act should be relaxed to accommodate the issuance of blind pools. Although there was a mixture of opinion among those surveyed, the predominant view was that the reauthorization of blind pools under the Marks-Roos Act is unnecessary and could lead to further abuse. It was recognized that a variable rate structure and the availability of bond insurance should mitigate some of the problems associated with blind pools in the past. However, most of those surveyed felt that the reauthorization of blind pools still would be likely to result in the overissuance of tax-exempt bonds that ultimately would be redeemed without being originated. This is a concern because artificially inflating the supply of tax-exempt bonds in this manner could indirectly raise interest rates for all municipal borrowers and attract attention from regulators.

At issue in the discussion of relaxing the 90-day restriction is whether there are potential advantages to local agencies, in terms of interest rate savings, issuance cost savings, or convenience that outweigh the potential risks that have been associated with past blind pool transactions.

The Enforcement Void

The persistence of questionable financing activity under the Marks-Roos Act, which in some cases appear to flout amendments to the Act enacted to prohibit such activity, points to a weakness in the self-regulatory model that theoretically ensures that municipal bonds are issued in compliance with state law. The bond counsel retained by the issuer is responsible for determining that the bonds are duly authorized under state law, in addition to reviewing disclosure documents for compliance with the securities laws and opining on the tax-exempt status of the bonds. In opining on the validity of a bond offering, bond counsel is supposed to be governed by a very conservative standard. Yet the number of bond offerings relying upon aggressive interpretations of the Marks-Roos Act points to a weakness in the self-regulatory model.

Of the three areas of law for which municipal securities offerings are reviewed for compliance by bond counsel – bond law, tax law and securities law – only the bond laws are not enforced by any governmental agency. The tax opinion of bond counsel may be challenged by the IRS or the state Franchise Tax Board. The completeness and accuracy of an issuer's disclosure documents may be challenged by the SEC or the state Department of Corporations, or even by investors. But the state's municipal bond laws – the Marks-Roos Act included – do not assign enforcement responsibilities to any state or local agency, and do not authorize civil or criminal penalties for violations of their provisions. Additionally, no professional organization, such as the California State Bar or National Association of Bond Lawyers, has in place a process to review the conduct of their members in this area.

Although the Marks-Roos Act does not specify penalties for violations of its provisions, any such violations could give rise to serious penalties under the tax and securities laws. If municipal bonds are not validly issued under state law, the bonds cannot be tax-exempt under federal or state tax law. The bonds could be declared taxable, which would harm bondholders, who in turn might sue the issuer and its bond counsel for damages. If the bonds are not tax-exempt or qualified private activity bonds, the bonds are not exempt from the registration provisions of the federal and state securities laws. The persons responsible for violating the registration provisions of the securities laws could be subject to civil and criminal penalties. But before this chain of events can unfold, a court first must rule that a violation of the law has occurred. This is where there is an enforcement void.

In response to this problem, state Treasurer Fong established an Interagency Municipal Securities Task Force in late 1996, consisting of representatives from CDIAC, the state Department of Justice, the state Department of Corporations, and the State Bar. The Task Force recently released its report which recommends that the Legislature direct the state Department of Justice to establish a program to review municipal bond offerings for compliance with state law, initially focusing on Marks-Roos bonds and other types of bonds with a high potential for abuse. The establishment of this program should have the effect of deterring aggressive interpretations of the Marks-Roos Act.

Summary

The flexibility in the local government debt issuance afforded by the Marks-Roos Act is at odds with the philosophy that public borrowing must be carefully controlled, a philosophy that has guided the development of much of California's constitutional and statutory provisions regarding indebtedness. Its very presence calls into question the rationale for many pre-existing statutory restrictions on the issuance of debt. The flexibility in issuance afforded by the Marks-Roos Act has resulted in savings of time and money for hundreds of local agencies. Yet the breadth and complexity of the Act may create the climate for abuse, as issuers, regulators and the bond market in general do not share a common conception of what the Act does and does not permit.

The Legislature's response to past abuses has been to "tighten up" the Marks-Roos Act – by restricting blind pools, curbing excessive administrative fees and outlawing roving JPAs. The fact that each of these problems has persisted in some form indicates a deficiency in enforcement of the law, rather than a flawed statute. In fact, the state's municipal bond laws – the Marks-Roos Act included – do not assign enforcement responsibilities to any state or local agency, and do not authorize civil or criminal penalties for violations of their provisions. Improving the enforcement of the state's municipal bond laws should have the effect of deterring aggressive interpretations of the Marks-Roos Act.

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