A REPORT BY
THE 2013-2014 CONTRA COSTA COUNTY GRAND JURY
725 Court Street
Martinez, California 94553

REPORT 1411

CAPITAL APPRECIATION BONDS

SCHOOL DISTRICT REPAYMENT PLANS

APPROVED BY THE GRAND JURY:

Date: 6/5/2014

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Contra Costa County Grand Jury Report 1411

CAPITAL APPRECIATION BONDS

School District Repayment Plans

TO: All School Districts in Contra Costa County

SUMMARY

There are 20 school districts in Contra Costa County, including the Contra Costa Community College District and the Contra Costa Office of Education. Seven have issued Capital Appreciation Bonds (CABs) to finance new schools or remodel existing schools. School districts regularly issue long-term bonds to finance long-term capital assets – such as a new high school. However, many voters are not familiar with the use of CABs to finance school construction and improvements.

CABs are long-term debt instruments that typically require payment of interest and principal at the end of the loan term, usually at the end of 20 to 30 years, and sometimes even more. A characteristic of CABs is that each year the accrued interest is added to the principal before interest is charged for the following year. The longer the bond issue the more interest to be paid at the bond's maturity.

The seven school districts in Contra Costa County that currently have CABs believe they can make all approved bond payments. This belief is based upon some long-term assumptions, including a growing economy.

School districts in Contra Costa County should seriously consider avoiding CABs in any future bond sale. In addition, school districts should consider including "callable" provisions in all future bond sales. Callable provisions allow an existing bond issue to be paid off at a lower interest rate than the original rate, which can significantly reduce interest payments.

METHODOLOGY

1. Survey results from the seven affected school districts.
2. Interviews with county and school district officials.
3. Review of Grand Jury Reports specific to CAB's from counties of San Diego and San Mateo.
4. Review of public documents and reports from around the state.
5. Review of *School Finance Handbook for TTCs* (TTC = Treasurers and Tax Collectors) published by the California Association of County Treasurers and Tax Collectors.

BACKGROUND

School construction has been financed through the sale of long-term bonds for a long time. Recently, a form of bonding that allows a school district to delay paying back the loan principal, often for decades, has become available. This "Capital Appreciation" type loan frequently requires school districts to make substantial interest payments. This form of financing has a long-term financial impact.

Prior to 2000, under the provisions of Proposition 13, a school bond measure required a 2/3 affirmative vote for the bond measure to be approved. With the passage of Proposition 39 in 2000, the law changed to only require a 55% affirmative vote for passage of a school bond measure. This change made it easier for school boards to seek approval of construction bond measures.

The California Education Code requires that school district borrowing for each bond ballot measure not exceed $60 per $100,000 of annual assessed valuation within the district boundaries for the repayment life of each bond issue. This tax rate limitation was intended to prevent a school district from financially overburdening taxpayers in its district. In addition, the California Education Code requires that unified school districts not borrow more than 2.5% of the district's total assessed valuation ("debt ceiling limit"). Non-unified school districts have a debt ceiling limit of 1.5% of the district's total assessed valuation. However, a school district may petition the State Board of Education and receive a waiver to go above the debt ceiling limit, as has been done by the West Contra Costa Unified School District.

School officials (school superintendents and boards) confer with professional bond consultants prior to the sale of CABs. A team of experts is hired to guide school officials through the complexities of the bond process. In Contra Costa County, this team usually includes school district officials, Contra Costa County Board of Education officials, underwriters, insurers, financial advisors, disclosure counsel, paying agents, verification agents, and bond counsel. The consultants work to ensure that each bond issue is legal.

Most voters and school board officials are familiar with Current Interest Bonds (CIBs). These are long-term debts that require payments of principal and interest every-six-months. These bi-annual payments are pre-determined by tax rate limits set forth in the ballot authorizing the bonds. These are akin to the familiar amortized home or auto loan.

By contrast, the less familiar CABs are long-term debts where the yearly interest is added to the principal and no payments are due for many years into the future. Succeeding yearly interest is charged against an ever-growing principal that is compounding annually and not due until the bond matures, which could be in 25 to35 years. CABs can become very expensive, typically exceeding 5 times the authorized loan. This is how a $2.5 million CAB, sold by the West Contra Costa Unified School District, possibly may become a $33.8 million obligation. The school district is not required to make regular payments until the entire principal and interest come due in 26 years.

Most bonds, especially traditional Current Interest Bonds (CIB), have a "call" provision where advance payments can be made to shorten the life of the bond and thus reduce the amount of interest that must be paid. Most school districts have used this provision by issuing lower interest rate bonds to pay off older higher interest bonds. CABs lack a "call" provision unless such a provision has been negotiated and stated in the bond issue.

Seven school districts have used CABs to finance part of their construction, although none of these districts has relied exclusively on CABs. Each has published debt service spreadsheets setting forth future yearly bond payments and projected property tax rate proceeds. The repayment schedules are generally structured in such a way as to pay off the CIB bonds first, therefore giving time for the tax rate to increase to the point that, using inflation adjusted future income, the CABs can be paid from regular tax receipts.

Current data for CABs at the seven school districts in Contra Costa County:

School District and Original Bond Series	Original Amount	Due at Maturity	Due Date	Bond Issued	Callable
Acalanes UHSD (A)	$ 29,999,819	$ 123,893,973	2025-2039	3/20/2010	Yes
Acalanes UHSD (B)	$ 37,999,106	$ 228,025,432	2028-2046	7/20/2011	Yes
Byron USD	$ 1,352,193	$ 4,285,000	2026-2032	10/9/2007	No
John Swett USD (A)	$ 266,175	$ 3,020,000	2030-2034	9/17/2009	No
John Swett USD (C-1)	$ 19,583	$ 140,000	8/1/2028	9/15/2011	Yes
Mt. Diablo USD (A)	$ 2,997,216	**SEE NOTE**	2016-2022	9/22/2011	Yes
Mt. Diablo USD (A)	$ 47,459,259	$ 154,752,537	2025-2035	9/22/2010	Yes
Mt. Diablo USD (D)	$ 943,582	$ 1,790,000	2015-2018	3/29/2011	Yes
Pittsburg USD (C)	$ 9,999,952	$ 34,806,365 **SEE NOTE**	2020-2042	7/14/2011	Yes
Pittsburg USD (C&A)	$ 9,663,211	>$ 30,000,000	8/1/2046	8/21/2012	Yes
Walnut Creek SD (E)	$ 1,964,628	$ 3,630,000	2014-2023	5/25/2010	No
West CCUSD (C)	$ 29,999,377	$ 97,455,000	2006-2034	8/11/2004	No
West CCUSD (D)	$ 99,998,106	$ 259,360,000	2007-2034	10/19/2005	No
West CCUSD (C-1)	$ 52,084,759	$ 190,830,000	2016-2033	9/3/2009	No
West CCUSD (D-2)	$ 2,499,949	$ 33,820,000	8/1/2034	6/24/2010	No
NOTE:	Interest on these is included in the bond series shown immediately below.				

The County Auditor-Controller's Office uses several factors to verify that the expected tax income projections will be adequate to make the twice-yearly bond payments on CIBs and provide a future reserve for both CIBs and CABs. Should the economy and assessed valuation not increase as projected to produce the expected tax revenues, the County Auditor-Controller has the authority to increase the tax rate on the property owners in that school district to an amount that covers the required bond payment.

Each of the seven school districts, through their consultants, have produced a plan — a spreadsheet — showing the rising bonded indebtedness and the estimated tax they must charge to successfully make all scheduled bond payments. However, these projections of future income rely on a steady increase in home and business valuations of 3% or 4%, compounded, per year. The school districts likely would face financial difficulties if the housing market does not increase for the next 20 to 30 years at this projected rate.

Should the spreadsheet projections not be realized for a school district, the County Auditor-Controller may increase the amount of taxes owed for properties in the school district to pay the bond premiums. As one district answered: "Each year, the Contra Costa County Auditor/Controller sets the tax rate in such a manner as to be sure to have enough funds on hand to cover the required debt service of the fiscal year, plus three months. The maturities of the CABs are timed along with the maturity of the CIBs to try to avoid significant spikes in the tax rates in the years ahead."

As stated in the *School Finance Handbook for TTCs*: "If Capital Appreciation Bonds (CABs) are part of the proposed structure, ask why? CABs are very costly to the taxpayer."

A joint statement to all District and County Superintendents, dated January 17, 2013 issued jointly by State Superintendent of Schools Tom Torlakson and State Treasurer Bill Lockyer strongly urged all school districts to not use CABs as part of any school financing package.

FINDINGS

1. Seven school districts in Contra Costa County have used Capital Appreciation Bonds to finance construction.
2. The high cost of Capital Appreciation Bonds has caused a higher, long-term debt for school districts in Contra Costa County that have used these bonds to finance construction.
3. It is preferable for bonds to contain a "callable clause."
4. Each of the subject school districts has a published repayment schedule of its Capital Appreciation Bonded indebtedness.
5. The Auditor-Controller of Contra Costa County sets tax rates for properties in a school district to make sure principal and interest to bonded debts are paid when due.
6. The County Tax Collector collects the taxes that are held in designated accounts of the County Treasurer for issuance of debt payments as directed by the County Auditor-Controller.
7. The State Superintendent of Schools, the State Treasurer, and the California Association of County Treasurers and Tax Collectors have urged local districts to halt any further use of Capital Appreciation Bonds as a means of funding construction projects.

RECOMMENDATIONS

1. All school districts should consider avoiding the sale of Capital Appreciation Bonds in the future.
2. School districts should consider including "callable" provisions in all future bond issues.

REQUIRED RESPONSES

	Findings	Recommendations
Acalanes Union High School District	1-7	1, 2
Byron Union School District	1-7	1, 2
John Swett Unified School District	1-7	1, 2
Mt. Diablo Unified School District	1-7	1, 2
Pittsburg Unified School District	1-7	1, 2
Walnut Creek School District	1-7	1, 2
West Contra Costa Unified School District	1-7	1, 2

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	Findings	Recommendations
Antioch Unified School District		
Brentwood Union School District		
Canyon School District		
Knightsen Elementary School District		
Lafayette School District		
Liberty Union High School District		
Martinez Unified School District		
Moraga School District		

Oakley Union Elementary School District		
Orinda Union School District		
San Ramon Valley Unified School District		
Contra Costa County Office of Education		
Contra Costa Community College District		