Grand Jury

Financial strategy by county, cities draws criticism

By ROBIN MUSITELLI
Sentinel staff writer

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IN 1987, when the Santa Cruz County supervisors decided they needed a $14 million building to house health services, there was one problem: county voters were unlikely to approve a bond issue to raise the money.

The supervisors opted to bypass the voters.

First, acting as the Santa Cruz County Public Financing Authority, they had a trustee, the First Interstate Bank of California, issue almost $23 million worth of securities to pay for construction of the building and to pay another lease.

The county then agreed to make what amounted to yearly lease payments to the bank to pay the interest on the bonds. Strictly speaking, the supervisors didn't incur debt. They have a contract.

They used the most in vogue form of municipal financing in the nation — a lease-purchase contract or certificates of participation, the same device employed by all of the cities in Santa Cruz County during the past decade.

Although certificates of participation are popular with government officials, a recent Santa Cruz County grand jury investigation detailed a downside to their use, including past improprieties, problems now corrected, in Scotts Valley and Capitola. More public oversight is needed, the jurors concluded.

Among the actions criticized:

- With excess uncommitted money from a bond pool about to be penalized by the Internal Revenue Service, Scotts Valley bought $12.5 million worth of Yuba City Assessment District bonds.
- At times in the 1980s, both Scotts Valley and Capitola did not keep adequate debt reserve funds, technically putting them in default of the leases although no payments were missed.
- Use of certificates of participation to buy land for parks. Jurors recommended using general-obligation bonds with voter approval instead.

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Popular financing method questioned

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Jurors indicated they have a fundamental problem with the philosophy of using lease contracts for government financing. Given the dual roles of authority that exist — elected officials doubling as directors of their financial boards — a small number of people is empowered to make major debt commitments without voter approval, said jurors.

"Clearly," they said, more public participation is needed before elected officials sign on the dotted line. They recommended independent citizen oversight groups, like one formed last year in Scotts Valley, be established.

"What is being talked about here is how our local government finances the building of roads, of bridges, of government offices, of jails, of schools, of parks and of the multitude of other services and facilities that we have come to take for granted," said the grand jury report.

"Our focus all along was to call to the attention of the public that there are devices, all perfectly legal, that make it possible for public agencies to commit to long-term debt without public approval," said Ted Faley, the outgoing grand jury foreman.

While government officials think they are acting in the public interest, the public is "simply not aware or involved in the decision-making process," the report said.

Government officials defend the lease contracts.

"We're not out there looking for excuses to issue more debt," said Santa Cruz City Manager Richard Wilson. "We've used certificates of participation to do things we're required to do. We have no alternative. When the federal government says your water quality will be 'X,' you must meet those standards."

Government officials haven't responded formally to the grand jury report, although last December, in response to the grand jury's interim findings, the supervisors rejected all its recommendations.

Given the state's steady inflation, supervisors said it makes economic sense to borrow money and pay it back with inflated dollars.

How it works

Simply, certificates of participation or lease-revenue bonds are lease-purchase contracts. Unlike general-obligation bonds, which require a two-thirds voter approval, lease payments are not a binding obligation on a municipality, so no voter approval is required. Payments on lease contracts are made from the municipality's tax revenue, user fees and other revenue sources that do not require voter approval.

The certificates are sold to individual and institutional investors, usually with rising interest rates for each year. For example, the interest rate on 1987 certificates of participation started at 6.75 percent and climbed by 8.3 percent in 2007.

When the payments are complete, the municipality owns the property.

Throughout the nation, municipal lease-financing is booming. With demand for services growing whilevoters are less willing to approve spending, state and local governments have resorted to lease-financing to fund such capital projects as schools, prisons, and courthouses.

Nationwide, $66.9 billion worth of lease-backed securities have been issued since 1980.

Use of certificates of participation has doubled since 1985, hitting a record of more than $13 billion in 1991, according to the California Debt Advisory Commission.

The biggest issuer

Restrained by Proposition 13, California has been the biggest issuer, with more than half of all new issues in 1991.

State Treasurer Kathleen Brown last year called municipal leasing an "anomaly" in the otherwise constrained public finance practices.

"Because of legal distinctions between leases and debt, local governments can avoid constitutional debt limits, most significantly voter approval requirements, by financing capital projects through lease-backed municipal securities," said Brown.

Unlike ordinary municipal bonds, they aren't backed by the "full faith and credit" of the municipality.

And since payments often must be made from operating funds, and compete with expenditures for, say, police, they are vulnerable in times of fiscal stress.

Jeff Thiemann, a director of municipal finance for the ratings group of Standard & Poors, said recently he expects a "few, but very few, issues will run into trouble as a result of local political controversy or financial stress.

"A government has a lot to lose by walking away from a long-term lease financed in the public markets," Thiemann said. "Beyond loss of the leased property, which is still usually the norm, a municipality would tarnish its name in the credit markets, which is not a wise move, particularly if the government plans to issue more debt of any type."

What was bought

Over the past decade, the county Board of Supervisors has incurred almost $97 million of debt using certificates of participation and lease-revenue bonds.

Among other things, the money has purchased Quail Hollow park in Ben Lomond, the Polo Grounds property in Aptos, equipment for sheriffs and firefighters and is being used to pay for LaSelva Library and the $14 million health services building on Emeline Street in Santa Cruz.

Santa Cruz city officials, from 1985 to 1992, have incurred $52 million of debt with certificates of participation, to pay for a recycling center, improvements to the landfill and water system, and the Cedar Street parking garage.

In Capitola, $13 million of certificates of participation since 1984 have paid for a gymnasium at New Brighton Middle School, shuttle bus parking lot, and the purchase of the Rispin Mansion property and the Pacific Cove Mobile Home Park.

Scotts Valley has a combined bond pool and certificates of participation debt of $41 million. The money has paid for City Hall improvements, expansions of waste and water treatment plants, bridge and sewer line repairs and road repairs.

Watsonville has used certificates of participation twice, once in 1989 for $410,0000 to pay for a fire drill tower and again in 1991 for $6 million for a downtown parking garage and high school auditorium.

Santa Cruz manager Wilson contends the payments on the lease-purchase contracts comprise a small portion of the city budget, which has a $31 million general fund. With the exception of landfill equipment, the money has been spent to meet federal and state mandates, said Wilson.

Nor do government officials consider the lease-purchase contracts a convenient way to circumvent a two-third vote needed before a city can issue general-obligation bonds.

"I don't consider it an end run. The public process is there with public hearings and approval by the City Council," Scotts Valley City Manager Chuck Comstock said.

Oversight questioned

The grand jury, however, found the lack of public understanding of this financing tool troubling. In Santa Cruz County, elected officials decide what will be built and how much will be borrowed, said the grand jury.

"Since we do elect these people, we do, in principle, exercise control over what happens," said the report. But because of the intricacies of the financing, even elected officials don't know all the details. The average citizen probably doesn't know and wouldn't understand, concluded jurors.

The solution, jurors suggest, is citizen oversight committees in each of the jurisdictions.

"How would they be appointed? What qualifications would they have? Would they have the authority to veto?" responded county Supervisor Fred Keeley. "It's a shallow recommendation and an unnecessary addition of another level of government. Oversight already exists with five elected officials."

The grand jury also found borrowed money was not spent as planned. In Scotts Valley, for example, a $34 million bond pool was issued in 1990 to finance reconstruction of Scotts Valley Drive, the city's main street, among other projects.

When the project was delayed, the city was left with money it had to spend or pay tax penalties in the "hundreds of thousands of dollars," according to Scotts Valley's Comstock. The spending deadline was one of the conditions of the bond.

Comstock said other cities in the county were asked if they had projects that could use the money, but none did. So the city refunded $4.5 million, and invested $12.5 million in Yuba City assessment district bonds.

The grand jury criticized that investment, saying "the practice of using borrowed funds to invest in another city's bonds is not desirable nor in the best interest of the city's taxpayers."

The investment is earning 8 percent interest, Comstock said, adding, "It was the best thing we could do."

In Capitola, payment errors were made in 1986 by the former trustee, Pacific Trust Co., the jury found. The errors, which drew the balance of a $1 million reserve account down to about $250,000, have been corrected and the reserve account replenished as of last September, according to Capitola Treasurer Glenn Hanna.

"Certificates of participation are a convenient method of creating debt without involving the public in a substantial way," said Hanna. "It just makes it a lot more easy for the politicians to do what they want to do. For that reason, I don't like it."

Public debt

Local governments have taken on substantial public debt, via certificates of participation and bond pools, without a public vote. These figures show the principal, but not the interest, still owed by each jurisdiction.

Jurisdiction	Amount
County	$65 million
County Redevelopment	$58 million
Scotts Valley	$46 million
City of Santa Cruz	$31.8 million
Santa Cruz City Redevelopment	$2.9 million
Capitola	$9.2 million
Watsonville	$6.4 million
Watsonville Redevelopment	$1.3 million

Source: grand jury report