LEASE-REVENUE BONDS **6872**

(New 5/98)

Definition: Revenue bonds (or enterprise revenue bonds) are a form of long-term borrowing in which the debt obligation is secured by a revenue stream produced by the project. Because revenue bonds are self-liquidating and *not* backed by the full faith and credit of the state, they may be enacted in statute and therefore do not require voter approval. .

Lease-revenue bonds are a variant of revenue bonds used in the state's capital outlay program. The revenue stream backing the bond is created from lease payments made by the occupying department to the governmental financing entity which constructs the facility. Generally, this entity is PWB or occasionally a joint powers authority (JPA) of which the state is a member. The financing authority constructs the facility, issues financing bonds, and retains title to the facility until the debt is retired.

Lease-revenue bonds do not require voter approval because the transaction is set up to mirror a typical *financing lease* (discussed in Section 6876), i.e., lease payments are due on a year-to-year basis and required only if the facility can be occupied. The California Supreme Court has reviewed and determined that the lease-revenue financing mechanism does not create constitutional debt. The court's decision framework is referred to as the *Offner-Dean rule.*

Nonetheless, bond rating agencies include lease-revenue payment obligations when calculating the state's bonded indebtedness burden. Thus, there is a distinction between the concept of *California constitutional debt* and *debt as defined by the municipal bond market*.

PWB's lease-revenue program is described in Section 6873. Lease-revenue programs for state capital outlay can also be implemented through JPAs, as described in Section 6874.

Fiscal highlights:

1. In contrast to GO bonds, annual appropriations are necessary for lease-revenue debt service. However, the obligation to pay is *not* extinguished if appropriations are not provided.

2. Government Code Section 15848 provides for debt service payment in the event of no budget.

3. Lease-revenue bonds pay interest at tax-exempt rates which are slightly higher than tax-exempt rates for GO bonds.

4. Lease-revenue payments are due only if there is "beneficial use and occupancy." If the facility cannot be occupied, no lease payment is due (i.e., abatement is a required element of the underlying lease). Because payments would still be owed to bondholders, rental interruption insurance is required for lease-revenue projects. In addition, lease-revenue bond issuances are sized larger than actual project needs primarily for:

    a. A capitalized interest account to pay debt service during the construction period until the facility can be occupied; and

    b. A debt service reserve fund. A reserve fund is created by the indenture or trust agreement and is usually funded from bond proceeds. Reserve funds are generally required by rating agencies for bonds other than GO bonds as a prerequisite for investment grade rating. A reserve fund is used to replenish the interest and principal accounts in case of deficiency or to pay debt service if no other money is lawfully available (i.e. insurance proceeds). Drawing on a reserve fund is absolutely a last resort and is an event frowned upon by the financial markets. The amount of the reserve fund is governed by tax law and, for state lease financings, is generally one-half of the maximum semi-annual debt service.

5. Lease-revenue debt service is structured as level debt payments (as opposed to level principal payments for GO debt service) because the repayment schedule must be similar to that for a commercial operating lease.

6. The term of the bonds cannot exceed the useful life of the facility.

7. Lease-revenue bonds are typically sold on a negotiated basis because the bond market has greater information requirements about the security underlying lease-revenue issues. A financing team, in place before the bond sale, helps meet these information needs.

Lease-revenue bonds may not be issued for any project for which a lease cannot be created. (Without a legally enforceable lease, there is no security for the issue.) .

(Continued)

(Continued)

LEASE-REVENUE BONDS **6872** (Cont. 2)

(New 5/98)

8. Lease-revenue projects may require interim financing for costs incurred before the bonds are issued. Interim financing for preconstruction costs for lease-revenue programs requires substantial assurance that the loan will be repaid in another manner in the event bonds authorized for the project are not sold. For PWB projects, this is generally in the form of Budget Act or statutory language which authorizes repayment of interim costs from a department's support appropriation.

9. DOF, STO, the client department (and in some cases DGS) all have roles in the successful completion of lease-revenue project financing. For further discussion, see Sections 6873 for PWB lease-revenue bonds, Section 6874 for JPA lease-revenue bonds, Section 6880 for preparing for a bond sale, and Section 6884 for continuing disclosure. Client department responsibilities are summarized in Section 6886.

10. Other lease requirements are set forth in Section 6876 under the heading "financing leases."