# 2014/2015 Santa Paula
# Budget and Finance Analysis
# S. Hamlin 8/25/2014

Note: This version supersedes all others

**Introduction: "The Missing $22 Million"**

On June 2, 2014, the city Finance Director, Sandra Easley, presented a proposed budget for the fiscal year 2014/2015.

A $35 million "City Wide" budget was shown, as well as a $13 million "General Fund" budget, followed by a discussion of a $29 million Capital Improvement Fund. *There were NO slides and absolutely NO discussion about the monies represented by the difference between the $35 million "City Wide" budget and the $13 "General Fund" budget.*

Most of the discussion that evening was about salaries and the Limoneira Grant, which had not yet been interjected into the General Fund budget. The Mayor made a comment about "people at home…think we have this money …but we don't…" Was this in reference to the $35 million total?

The Finance Director explained that bond proceeds would be used for capital projects. At which point, someone asked about the balance of the bonds, to which the director replied "23 million". Thus the seed to equate the missing difference of $22 million to capital projects was planted, which of course did not make sense. The budget was approved 5-0 with no further discussion.

After a period of about ten days, the approved version appeared on the city's website. I was provided with a copy of the most recent audited Financial Statements for the fiscal year just ending. I also researched various bond databases for status on the city's bond sales.

I then embarked on a data gathering exercise to determine what contributed to the missing $22 million not discussed at the budget meeting.

**Overview of the Presentation at Council**

The Finance Director summarized the budget as follows:

| | *City wide* | | *General Fund* | |
|---|---|---|---|---|
| **Expenditures** | $34,565,177 | | $12,596,327 | |
| Salaries | $7,609,524 | | $5,775,373 | |
| Benefits | $4,669,929 | | $3,585,023 | |
| Operating Expenses | $20,885,464 | | $3,139,931 | |
| Capital | $1,400,260 | | $96,000 | |
| **Revenues** | $35,406,258 | | $13,069,829 | |

As previously stated, the presentation did not mention the difference between the General Fund column and the Citywide column, as shown below in the shaded column labeled 'Difference ???', nor were there any questions from any council members about the difference between the Citywide budget of $35.4 million and the General Fund budget of $13.0 million. What contributes to the $22 million difference as shown below in the shaded chart?

| | *Citywide* | | *General Fund* | | *Difference ???* |
|---|---|---|---|---|---|
| **Expenditures** | $34,565,177 | | $12,596,327 | | $21,968,850 |
| Salaries | $7,609,524 | | $5,775,373 | | $1,834,151 |
| Benefits | $4,669,929 | | $3,585,023 | | $1,084,906 |
| Operating Expenses | $20,885,464 | | $3,139,931 | | $17,745,533 |
| Capital | $1,400,260 | | $96,000 | | $1,304,260 |
| **Revenues** | $35,406,258 | | $13,069,829 | | $22,336,429 |

**$22 million, the Elephant in the Room**

How could the city plan to spend $29 million on capital projects without a prioritization schedule and without the manpower to manage such projects? Does it make sense to deplete the entire balance of the bond proceeds?

What does the $22 million "difference" column really represent? Why no elaboration? Why the dead silence from the five council members?

How and where was the bond accounting? When were the bonds sold and how many at what rate? What was the status of the refinance of the Waste Water Facility? No mention was made.

**Mystery Solved**

The city's budget consists of dozens of "funds". Fund 100 General Fund is the operating fund, plus Fund 610 Waster Water Fund and 620 Water Fund are called "Enterprise Funds" and they have associated Profit and Loss (P&L) statements.

The funds (100, 610, and 620) are NOT optional. Funds 610 and 620 represent **54% of the total expenses**. There is also a category of "special funds". Why were these monies ignored?

Below is an overview of the complete budget picture recast with all monies present. **The shaded area was neither presented nor discussed at the council's budget meeting.**

Santa Paula 2014/2015 Budget Summary

| | Revenues | Expenditures |
|---|---|---|
| General Fund | 13,069,829 | -12,825,830 |
| Special Funds | 3,133,878 | -2,995,550 |
| Water/Sewer Funds | 18,643,868 | -18,687,797 |
| Total City Funds | 34,847,575 | -34,509,177 |
| Development Impact Funds | 329,180 | -65,000 |

Note: there were a few changes to the budget after the presentation, so the numbers in the above chart are close, but not identical to that made by the Finance director at the council meeting shown on the first page of this document.

**Analysis of "Recast Budget"**

Let's look at some of the biggest values in the above chart:

1. $6,800,000 to PERC

Fund 610 Waste Water includes an expense of $6,800,000 to PERC for the operation and payment of the Waste Water facility. The Audited financial statements show the "minimum lease obligations" for next year at $5,362,095. What contributes to the $1.2 million difference in budgeting?

2. $10,692,000 revenue for the WWF and $7,848,868 revenue for Water

This is the amount to be collected from the users' water and sewer bills. At one of the community meetings, it was stated that there are about 7500 water bills issued monthly. If we divide $10,473,677 + $7,848,868 by 7500, this yields about $206 per month per bill. Does this amount seem familiar? There is a fee of $601,650 for "Water Replenishment Fee", which equates to $6.69 per month per bill. Could this be the notorious bill from the water district which has been blamed for our high bills?

3. 'Difference' Column Obfuscated

The $22 million not discussed at the council meeting was primarily monies for the water and sewer "enterprises". Why was this topic ignored, particularly when these monthly bills are a major source of residents' concerns?

4. Bond Payments

Below are the budgeted amounts for the Water and Sewer bond payments:

| Public Works Fund Number | Principal Due Bondholders | Interest Due Bondholders |
|---|---|---|
| 610 | 210,000 | 668,666 |
| 620 | 1,370,000 | 2,559,938 |
| Total | 1,580,000 | 3,228,604 |

However, last year, the audited Financial Statements show the following bond payments:

| FY2013/2014 Audited Financial Statements | Water | Sewer | Total |
|---|---|---|---|
| Interest Paid on Capital Debt | 2,494,081 | 4,258,030 | 6,752,111 |
| Principal Paid on Capital Debt | 1,295,000 | 1,816,397 | 3,111,397 |

This large difference between what was paid on the bonds last year and what was budgeted for the upcoming year could be explained by a piece of financial arbitrage called *bond defeasance* (see paragraph in italics below) which was divulged in the 2013/2014 audited Financial Statements.

*In February 2010, the Santa Paula Utility Authority, the "Utility Authority" (a component unit of the City of Santa Paula) issued $55,715,000 aggregate principal amount of Water Enterprise Revenue Bonds, 2010 Series, with proceeds used to effect the advance refunding of $25,700,000 of outstanding Santa Paula Public Financing Authority Water Revenue Bonds, Series 2003, finance certain improvements to the Authority's water system, fund a reserve account, fund capitalized interest on the non-refunding portion of the Water Bonds and pay costs of issuance for the Bonds. Of the $57,570,826 net proceeds from the 2010 Bonds, $27,483,814 plus an additional $1,160,572 of 2003 Bonds reserve fund monies were used to purchase U.S. Treasury Securities - State and Local Government Series. Those U.S. Treasury Securities - State and Local Government Series were deposited in an irrevocable trust with an escrow agent to provide for all future debt service payments on the 2003 Series Bonds. As a result, the 2003 Series Bonds are considered defeased and the liability for those bonds has been removed from the financial statements.*

First it is important to understand the concept of "defeasing" bonds. A bond issuer can use new bonds to pay off old bonds by setting aside enough principal to pay the interest on the old bonds and the principal as it comes due. There could be several reasons why an entity would defease bonds.

- If the interest on the new bonds is higher than the old bonds, it would take less new principal to service the old principal, but this condition has not been true since the 1980's,
- If the entity had a large cash windfall, the cash could be set aside, dedicated to servicing the bonds.

In either case, the liability of the "defeased" bonds is removed from the balance statement, thus improving the entity's balance sheet. Santa Paula's use of bond defeasance could be an attempt to improve the balance sheet in preparation for a new issuance. In 2013 the wastewater bonds were revised to negative on "thin margins", as described below:

> Outlook Revised To Negative On Santa Paula, CA Wastewater Enterprise Revenue Bonds On Thin Fiscal 2012 Margins
>
> SAN FRANCISCO (Standard & Poor's) April 19, 2013--Standard & Poor's Ratings Services revised its outlook to negative from stable on Santa Paula Utility Authority, Calif.'s wastewater enterprise revenue bonds issued for the City of Santa Paula. At the same time, we affirmed our 'A+' rating on the bonds.
>
> The revised outlook reflects our view of the wastewater enterprise's thin financial margins in fiscal year 2012 based on fixed charge coverage, and the uncertainty regarding future rate increases given that service rates are currently very high and the previously approved fiscal year 2013 rate increase was deferred," said Standard & Poor's credit analyst Tim Tung.
>
> The rating reflects our opinion of the wastewater enterprise's thin fixed charge coverage of 1.07x based on audited fiscal year 2012 financial results, very high service rates that constrain management's revenue-raising flexibility, service area economy located in Ventura County that has experienced high unemployment rates during the past 36 months, and declining liquidity position during the past four fiscal years.
>
> Source:
> http://www.bondsonline.com/Todays_Market/Credit_Rating_News_.php?DA=view&RID=30780

While the arbitrage did improve the city's balance sheet, about half of the proceeds from the $57 million dollar sale were lost to defease the 2003 bonds. **Essentially, borrowed money was used to pay for borrowed money.** The full interest payment for the $57 million and accrual for the principal will still be necessary, but the city will only get to use about half of the proceeds, thus doubling the effective interest rate of the 2010 bonds.

Perhaps the city was considering another bond offering to buy out the Waste Water Facility on which the city is paying a usurious rate of 8%+ to Alinda Capital. According to the original agreement, the earliest buyout date would be in 2028 with onerous termination fees, so another bond issuance is unlikely.

**Conclusion**

The $22 million "elephant in the room" should have been included in the public's presentation of the budget.

The conflation of the capital funds with enterprise funds and the general fund should be explained. The implication that the "difference" column shown on page 1 of this report is due to the Capital Improvement projects is a sleight of hand that was passed off without question from the five sitting council members.

The lack of questions indicates that the five members of the council do not have the background to question the report or they have had a prior meeting to flush out details and ask questions, which is, of course, a violation of the Brown Act.

In any event, this should give the voters pause as to which candidate will have the ability to sift through city financials in a more meaningful way than that displayed at the council meeting.

Three of the five members at the dais voted for the 8% PERC deal: Luna (previous council), Fernandez and Gonzales. This should be another consideration for your vote.