Municipal Bonds, Santa Paula and Waste Water
2008 to Present

Myth and Reality

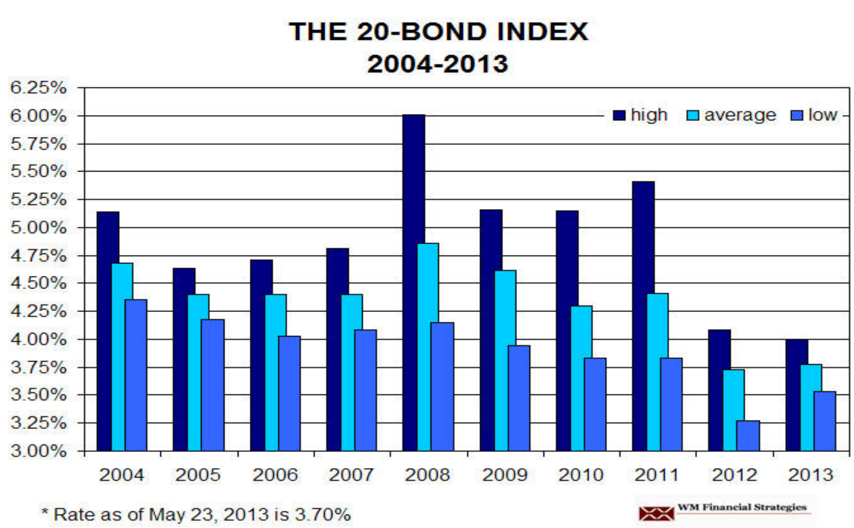
Early 2008 when Santa Paula was considering its new Waste Water Facility (WWF), there were traumatic events in the financial markets. Here is a quick summary.

In the 1980's, a Wall Street firm Drexel Burnham Lambert created a listed security called a CDO, collateralized debt option, which included mortgages bundled for sale in pieces or tranches, as they were called. By breaking the mortgage cash streams into pieces, many investors could buy into these streams. Drexel, by the way, was the junk bond firm where Michael Milken made his mega-deals. It filed for bankruptcy in the 1990's and Milken served two years in prison on a reduced sentence.

As the real estate frenzy escalated after the Internet bubble burst in 2001, demand for CDO's increased. But in 2007, real estate values supporting the CDO's started to drop and consequently, the value of the CDO's started to drop, along with every sophisticated derivative that had been created around the CDO's. Every mutual fund who had invested in the CDO's lost value. Bond insurers were taking huge losses on these securities. There was a run on mutual funds containing CDO's. Government entities who had invested in the CDO's also incurred losses.

Several notable defaults of 2008 were Jefferson County and Vallejo California. Jefferson County got caught in a derivative called an interest rate swap and Vallejo California had placed too many budget bets on the declining housing market. And, of course, everyone knows that AIG was rescued and Lehman Brothers was allowed to go bankrupt with its assets carved up by the world banking community.

Yes. 2008 was tumultuous, particularly regarding anything to do with housing and securities relating to mortgages. But municipal bonds are not CDO's and the muninicipal bond market did not die. Bond insurance became expensive and interest rates rose. The chart below shows municipal bond interest rates for this period:



From the Fed (Federal Reserve Bank) Flow of Funds report, we see the following flow in billions of dollars for the years 2005-2013. Note that a positive number means that sales were greater than redemptions or refunding, while a negative number is the reverse. Redemptions and refundings outpaced sales for the years 2011-2013 when investors where rushing into equities.

F.4 Credit Market Borrowing
Billions of dollars

	2005	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*
Municipal securities	198.1	170.0	235.5	92.4	155.3	99.7	-52.8	-4.9	-43.2

The myth that has been perpetuated locally was also reiterated in the 2012 Ventura Grand Jury Report as follows:

> … The FCS report stated that no guaranteed financing could be obtained for the Veolia bid in the “ultra-turbulent financial period” of 2008. Veolia’s bid included an $8 million construction loan with no long term financing. The selection of Veolia would require the sale of bonds for the cost of construction of the facility at a time when financial markets were in turmoil. PERC’s bid included fixed 30 year financing…

In review of the FCS Group website, there are many skills listed; however, nothing indicates expertise in the bond market. Here are the obvious questions:

- Why was FCS chosen to evaluate the financial aspects of the two bids for the WWF?
- Did Santa Paula obtain a bid from one or more underwriters of municipal bonds?
- Did Santa Paula hire a bond advisor?
- Did the Ventura Grand Jury ask about these details because there was no mention of bond bids in the report.

Without a bid from a bond underwriter, it would have been impossible to compute the net present value of the cash stream of the Veolia bid, so a comparison between the PERC and Veolia bid would have subsequently been impossible.

Public Markets versus Private Capital

When an agency, such as a city, needs money to fund a project, the agency hires a bond advisor who surveys the market and suggests an initial pricing for some amount of municipal bonds, either taxable or non-taxable. The bond advisor will circulate the potential bond to underwriters, who are securities brokers who specialize in bonds. One or more underwriters may participate in the deal. Most underwriters have existing clients who are looking for new bond issues so the advisors take this into consideration when presenting underwriters to the agency. There are also legal and accounting advisors, particularly in tax-free issues.

The municipal bond market is a public market, where each bond is given a CUSIP number used to identify the bond for trading and accounting purposes. Unlike stocks, there is no ticker symbol. The biggest buyers of municipal bonds are pension funds who need a continual and secure yield for their portfolio, as well as many high net worth individuals and families.

Bonds are priced daily and can be sold at any time. This is a key difference between bonds and private placements. The municipality sells the bonds, gets the money from the sales minus costs and must accrue to repay the principal and pay the semi-annual interest on the bond coupon. The agency uses the money for the project and owns the project.

Firms like Alinda Capital work with clients who have private capital to invest. Alinda approaches a municipality or county with a project that needs funding and offers to fund the project using private capital from its own clients. It will take a commission and/or a management fee and promise its client(s) a guaranteed income stream from the investment project for a specified period of time. There is no public market for private investments.

The agency whose project is funded by Alinda generally does not own the resulting project. In Santa Paula's case, there is a lease/operation fee that is paid to PERC/Alinda. Santa Paula may buy out the lease, but the earlier the buyout, the more expensive the buyout price because Alinda's clients lose their income streams, so this loss has to be made up in the buyout price. A buyout schedule I saw showed 2028 as the earliest buyout date with termination fees descending after that date. The 2012 Ventura Grand Jury report mentions a five year buyout, which seems *highly unlikely* given that Alinda's clients are pension funds desperate for high yields. If such a five year buyout exists, the price will be exorbitant.

Obvious questions would be:

- With Santa Paula's bond rating reduced, how would it expect to raise the funds required to buy out the plant, which would probably be in the $60 - $70 million range?
- Does Santa Paula have a financial consultant retained, who can make complex financial considerations and who specializes in municipal bond financing?

Reality

Santa Paula has budgeted revenues of $18,643,868 million in its 2014-2015 budget for water and sewer. See table below. Note the shaded rows were not shown to the public in the televised presentation of the budget on June 2, 2014.

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

$18.643.868 equates to $207 per water bill per month given 7500 water bills in the enterprise. Without reducing the annual payment to PERC/Alinda of $6,800,000 there will be no rate reduction. Details of the 2014/2015 budget can be found in a previous document listed in the sources on the last page.

The council has unfortunately raised expectations about new rate payers in East Area I, but that will be a decade or more before realization of profit due to the associated costs of bringing water to that area.

Another option would be the sale of the treated wastewater to commercial clients, which would require an upgrade to the facility. This could be a possible use of the remaining $23 million in bond money from the 2010 sale. The State of California has provisions for helping low income communities in the Water Bill on the November 2014 ballot.

Here were the votes on the Perc/Alinda deal:

“Yes” Votes
- Council members Gonzales
- Council Member Fernandez
- Former Council Member Luna

“No” Votes
- Council Member Procter
- Council Member Aguirre

Going forward, the reality is neither easy nor quick.

Sources:

1. http://www.munibondadvisor.com/bondsgonewild.htm
2. http://www.federalreserve.gov/releases/z1/current/annuals/a2005-2013.pdf
3. http://vcportal.ventura.org/GDJ/docs/reports/2012-13/Santa_Paula_Waste_Water_Treatment_Plant.pdf
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5. http://blogs.reuters.com/muniland/2011/12/09/found-800-billion-in-municipal-bonds/
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