A Review of The Orange County Recovery Plan as Proposed August 22, 1995

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BACKGROUND

On December 6, 1994, Orange County and its investment pool filed for protection under Chapter 9 of the U.S. Bankruptcy Code. The Chapter 9 filing followed a $1.7 billion loss in the pool's investment portfolio.

Investment Pool Losses. The pool consisted of funds from Orange County as well as approximately 240 other local agencies, including school districts, cities, and special districts. A significant share of the pool consisted of proceeds of debt issuances by the County and other agencies, some of which were made for the purpose of investing in the pool. Overall, the County's pool losses were about $700 million, while non-County losses were about $1 billion. On average, pool participants received 77¢ on the dollar from the liquidation of the pool.

Claims in County Bankruptcy Total $1.9 Billion. In addition to the $1.7 billion pool loss, the County faces about $200 million of additional claims and costs due to the bankruptcy and the County's related budget problems. Specifically, the County owes $100 million to vendors and employees, $25 million for bankruptcy expenses, and has incurred additional interest payments on approximately $1 billion of County notes that came due in the summer of 1995, but which the bankruptcy court has approved extending for one year.

Recovery Bonds Addressed a Small Portion of Claims. Recovery bonds financed by an ongoing diversion of a portion of the County's vehicle license fee revenues were issued in June, primarily to mitigate losses to schools. The recovery bond proceeds covered $244 million of the pool losses as follows:

- Schools received 13¢ on the dollar, bringing their recovery to 90¢ on the dollar.
- Most other pool participants received 3¢ on the dollar, bringing their recovery to 80¢ on the dollar.

The Recovery Plan

The County and representatives of major non-County pool participants have reached tentative agreement on a recovery plan to address the $1.7 billion of claims remaining after the issuance of the June recovery bonds. The plan is a key step toward the court filing of a "plan of adjustment" that resolves the claims against the County, and enables it to emerge from bankruptcy. Certain provisions of the plan require changes to state law, as noted below.

Scope of Report

The purpose of this report is to provide the Legislature with a framework for evaluating the proposed legislation to implement the recovery plan. Specifically, the report:

- Assesses the viability of the plan, and
- Comments on the major impacts of the plan.

OVERVIEW OF THE PLAN

The recovery plan contains two key components. The plan:

- Groups all bankruptcy claims into four categories;
- Specifies the financing to be used to repay each category of claims.

Establishes Payment Categories

The proposed recovery plan establishes four major payment categories for claims against the County, as shown in Figure 1.

Figure 1

Payment Categories Addressed by the Proposed Orange County Recovery Plan

(Dollars in Millions)

Category	Included Claims	Amount Provided by Plan
1. Public Debt Issue/Debt Restructuring, Asset Sales	• Principal and interest on County notes issued prior to bankruptcy. • Deficiency in long-term debt reserves. • Payments owed to County employees. • Payments owed to vendors. • High-priority County claims. • Bankruptcy costs.	$554
2. County Notes (IOUs)	"Option B" Pool Claims—Losses to non-County pool participants who maintain their claims against the County	44
3. Annual Budget Allocations	Losses to County administered special funds, including trust and fiduciary accounts	250
4. Litigation Proceeds	• "Option A" Pool Claims—Losses to non-County pool participants who agreed to accept partial restitution from the County and to rely on litigation proceeds for the balance.	817
	• Potential additional recoveries for the County, the Orange County Transportation Authority, and Option A participants.	N/A

Category 1—County Debt Repayment and Other High Priorities. These claims receive the most immediate and secure funding under the plan. Payment would come from a public debt issue by the County and from refinancing of County debt and asset sales. About $364 million of Category 1 claims are for the repayment of notes that were due this summer, but whose maturities were extended until June 1996 because of the bankruptcy.

Category 2—IOUs for "Option B" Claims. The plan calls for the County to give "County notes" (essentially IOUs) to "Option B" claimants. These are the small number of pool participants (certain cities and special districts) that did not agree to drop their legal actions against the County for their losses. Option B participants received 77¢ on the dollar from the pool liquidation, but did not share in the proceeds of the recovery bonds.

Category 3—Annual Budget Allocations to County-Controlled Funds. The County administers a wide variety of special funds and accounts that were invested in the pool and consequently suffered losses. These accounts include unapportioned taxes, funds for waste management, flood control, roads, airports, and fire protection, as well as child support collections and employee deferred compensation contributions. Annual budget payments from the County general fund would gradually restore these losses. (Fifty million dollars of high-priority County fund needs are included in Category 1).

Category 4—Remaining Claims and Restitution Depend on Litigation. "Option A" pool participants agreed to share in the proceeds of the recovery bonds in exchange for dropping their remaining claims against the County. Remaining claims for schools (all in Option A) are 10¢ on the dollar and for other Option A participants are about 20¢ on the dollar. The plan also identifies litigation proceeds as a potential source of restitution to the County and to the Orange County Transportation Authority (OCTA), which would help finance the plan, as discussed below.

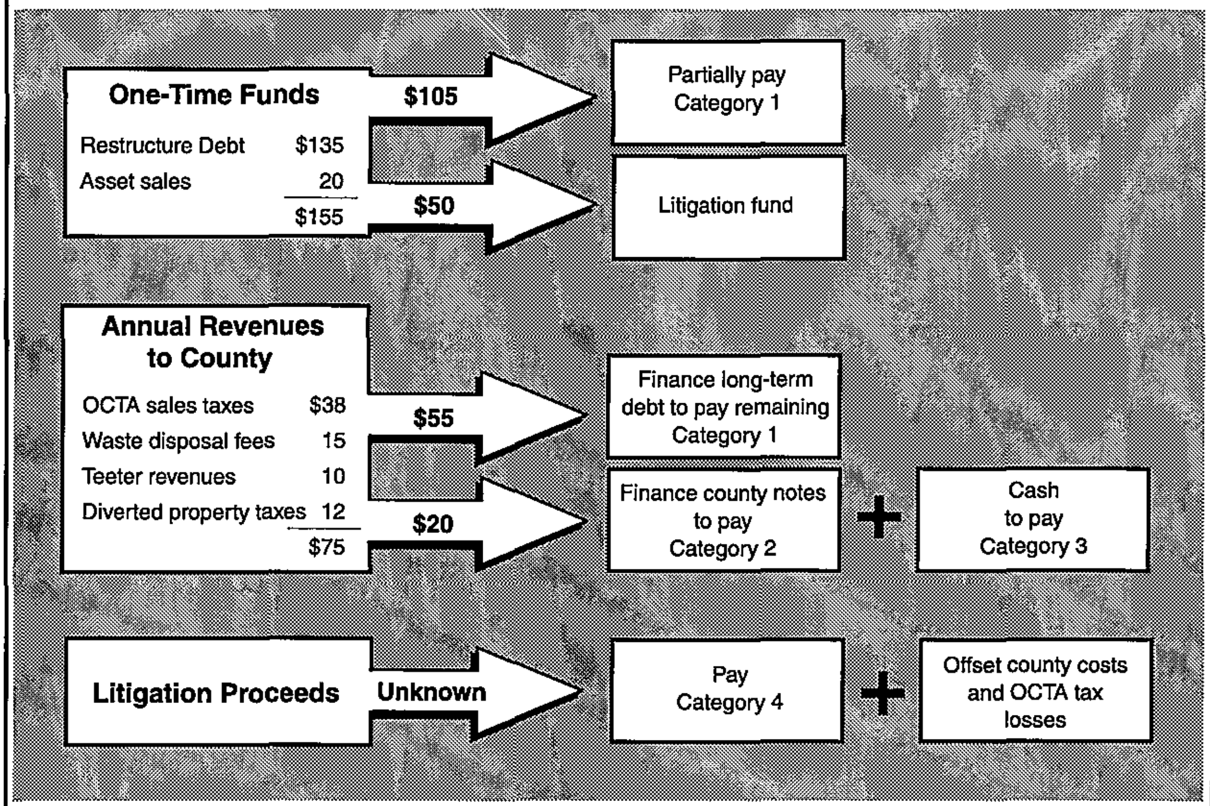
Identifies Financing

Figure 2 displays the major financing elements of the proposed plan and delineates the sources of funding for the plan.

Figure 2

Orange County Recovery Plan As Proposed August 22, 1995 Sources and Uses of Financing

(In Millions)



Diverted Tax Revenues. The plan annually redirects a total of $50 million in tax revenues to the Orange County general fund as follows:

- $38 million of annual local sales tax revenue for transportation (pursuant to the Transportation Development Act—TDA) would be diverted from the OCTA for 15 years beginning in 1996-97. In exchange, the County will transfer $23 million in gas tax revenues annually to OCTA, beginning in 1997-98 for 16 years, as shown in Figure 3.

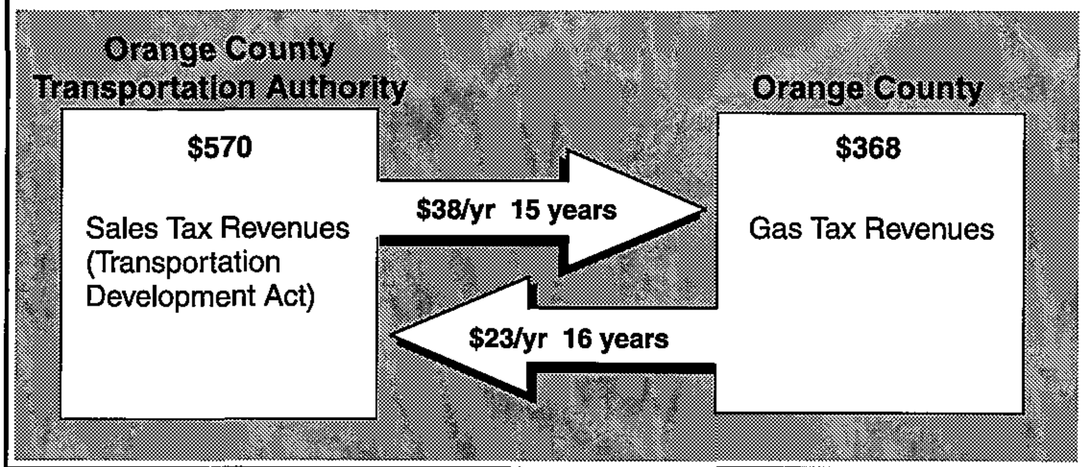
- $12 million of annual property tax revenue would be diverted from County-dependent special districts and County redevelopment agencies for 20 years.

All of these tax reallocations would require legislation.

Figure 3

Orange County Recovery Plan
Transportation Funding Component

(In Millions)



Additional County Non-Tax Revenues and Budget Reductions. The plan relies on County receipt of $25 million annually from increased waste disposal revenues and a restructured "Teeter" program for collecting delinquent property taxes. The plan also assumes that the County will earn one-time additional revenues of $155 million from refinancing existing County debts and selling County assets. Debt-service costs on the June 1995 recovery bonds already have been built into the County's budget. However, the bonds are structured so that the annual debt-service cost increases by $10 million after the first five years, which the County would need to absorb within its budget under the recovery plan.

Litigation Proceeds. The plan proposes to pay over $1 billion in claims and other reimbursements from litigation proceeds.

WILL THE PLAN REPAY ALL THE CLAIMS?

As Figure 2 illustrates, three categories of claims are supported by a $75 million revenue stream that includes reallocated property taxes, waste disposal, and Teeter revenues. The first call on this revenue stream is repayment of debt issued to satisfy Category 1 claims. The County's financial consultants estimate that these costs will be approximately $55 million annually. Category 2 and 3 claims are to be paid from the $20 million remaining in the revenue stream.

Our review indicates that there are several uncertainties regarding the proposed revenue stream and the amount of funds required for debt service. Below, we discuss the impact of these uncertainties on the repayment of the County's claims.

Category 1 Claims Are Secure

The recovery plan proposes that the County will issue $520 million of long-term debt to fully repay all Category 1 claims and repay this debt with revenues shown in Figure 2. Our review indicates that even if all the uncertainties regarding this revenue stream materialize, the County still will have sufficient revenues to support the issuance and repayment of the public debt. Moreover, the plan proposes to guarantee repayment of this debt through the Motor Vehicle License Fee intercept mechanism established by Chapter 2xx, Statutes of 1995 (SB 8xx, Lewis).

Category 2 and 3 Claims Are Less Secure

Because Category 2 and 3 claims are paid *after* debt-service costs are deducted from the revenue stream, our review indicates that the timing and extent to which these claims will be repaid is uncertain. Specifically, should any of the four factors discussed in Figure 4 materialize, revenues available to the County to pay these claims could fall below the needed $20 million. Furthermore, the County's ability to offset any unrealized revenues with general fund budget reductions may be constrained by its fiscal condition.

Figure 4

Concerns Regarding Revenue Stream

Waste Disposal Revenues May Not Last for Life of Plan

- Revenue estimates for the first five years appear reasonable; however, there is considerable uncertainty regarding the viability of waste disposal revenues after this point.
- Assumes the County accepts out-of-county waste at rates substantially lower than those charged to Orange County residents.
- Addendum A provides a detailed look at the waste disposal proposal.

Diversion of Taxes From Redevelopment Agencies May Be Unconstitutional

- Article XVI, Section 16 of the State Constitution specifies that redevelopment property tax revenues must be used to pay "indebtedness" of a redevelopment agency incurred by the agency to finance or refinance a "redevelopment project."
- There is considerable uncertainty as to whether the Legislature may redirect redevelopment property tax revenues into a county general fund.

Interest Rate Risk

- Any increase in projected interest rates or cost of issuing the $520 million in public debt will decrease the amount of revenues remaining to pay Category 2 and 3 claims.
- For example, each 1/10 of a percent increase in interest rates raises annual debt-service costs by about $500,000.

Asset Sale Amount May Be Lower

- The recovery plan includes raising $20 million through sales of County property prior to the end of the County's fiscal year. Our review indicates that the County will probably fall $3 million to $4 million short of this $20 million goal.
- Any unrealized asset sales will require the County to issue more than $520 million in public debt, thereby increasing County debt-payment costs and leaving less revenues available to pay Category 2 and 3 claims.
- A $4 million increase in the size of the public debt offering would increase annual debt-service costs by about $400,000.

Category 4 Claims Depend on Litigation

As mentioned above, the payment of any of the Category 4 claims of pool participants depends on the success of the County's litigation seeking to recover all of the pool's losses from Merrill Lynch and other firms. The plan includes a $50 million fund to finance this litigation under the supervision of an appointed trustee. The plan also establishes priorities for distributing any proceeds, as shown in Figure 5.

Figure 5

Distribution of Potential Litigation Proceeds Orange County Recovery Plan[a]

(In Millions)

	Option A Claims				
Amount (in priority)	Schools	Other	County	OCTA	Cumulative Total
$53	$53	—	—	—	$53
324	—	$324	—	—	377
176	—	—	$176	—	553
705	57	420	229	—	1,258
400	—	—	300	$100	1,658
125	—	—	—	125	1,783[b]
Totals	**$110**	**$744**	**$705**	**$225**	

[a] Based on preliminary proposal of August 22, 1995.

[b] Any recoveries in excess of this amount would be shared by Option A participants and the County.

Option A Claims and County Have First Call. Option A pool participants would receive the first $377 million of litigation proceeds. Of this amount, schools receive the initial $53 million in order to bring them up to 95¢ on the dollar. Other Option A participants would receive the next $324 million, which would increase their recovery to 89¢ on the dollar. The County would receive all of the next $176 million. After total proceeds reach $553 million, the next $705 million would be distributed approximately 65 percent to Option A claims and 35 percent to the County. This distribution would repay all remaining Option A claims (without interest) and provide an additional $229 million to the County.

The OCTA Also Could Benefit. After all Option A claims are paid, then the OCTA would receive $225 million from the next $525 million of proceeds—with the County receiving the other $300 million. The OCTA's share would cover revenue diversion under the plan. Finally, if litigation proceeds exceed $1.8 billion, then this excess would be shared by Option A participants and the County.

If litigation successfully recovers a large portion of the pool losses, then the fiscal impact of the plan on the County and on the OCTA could be substantially reduced or even eliminated. However, the prospects for, and the potential timing of, any litigation proceeds are speculative at present.

WHAT WILL BE THE IMPACT ON THE COUNTY?

Our review of the County's budget outlook was limited by the lack of detailed information regarding (1) the specific actions taken to achieve the budget reductions in 1995-96 and (2) revenues, mandated spending, and workload measures. Thus, while the County has adopted a budget *plan* which reduces spending significantly, we were unable to verify whether the lower spending targets will be fully realized, or whether the cuts will be sustainable in the future. This is important since the success of the recovery plan ultimately rests on the County's ability to maintain fiscal balance over time.

The following discussion is based on the overall budget figures provided by the County.

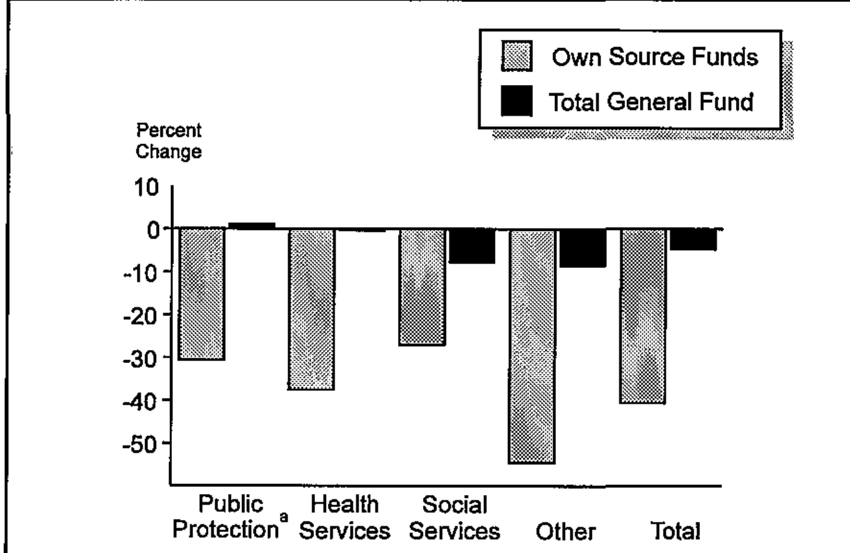
Current Budget

Orange County did not significantly reduce expenditures following the property tax shift to schools beginning in 1992-93. Instead, the County was able to avoid these cuts by adopting high risk/high return investment practices and using the interest earnings to balance its general fund until last year. The major loss in the investment pool, however, caused interest earnings to fall $152 million below the budget estimate in 1994-95, thereby requiring major spending cutbacks.

Specifically, the County adopted budget cuts in March 1995 which reduce spending financed from the County's own tax revenues from $463 million in 1994-95 to $275 million in 1995-96, a decline of 41 percent. The impact of these cuts on overall County spending is much less severe, however, because the County receives substantial program revenues from the state and federal government. As indicated in Figure 6, total County general fund spending (which includes these state and federal funds) declines 4.7 percent between 1994-95 and 1995-96.

Figure 6

Orange County Budget
Expenditure Changes By Program
Percent Change 1994-95 to 1995-96



[a] Adjusted for shift of fire protection to joint powers authority in 1995-96.

The County indicates that it has eliminated about 2,500 positions (about 15 percent of its workforce), mostly through attrition. It has laid off between 400 and 700 employees.

Impact On Future Budgets

Even if current budget reductions are fully achieved, the investment losses will constrain Orange County budgets for many years to come. From 10 percent to 15 percent of County tax revenues will be earmarked for debt service on the recovery program. In addition, the 1995-96 budget relies on a one-time drawdown in reserves of $15 million which will not be available in 1996-97 and beyond.

These factors will further squeeze County resources in the future. The County's fiscal health will ultimately depend on a variety of factors such as the strength of its economic base and future demand for public services. However, since the County is near its maintenance of effort requirements in its public protection, health, and welfare programs, it will have limited flexibility to deal with unanticipated events which may arise in the years ahead.

How Will the Plan Affect Other Local Agencies?

Transportation Programs

As discussed earlier, the plan will divert $38 million annually in TDA sales tax revenues from the OCTA to the County. In exchange, the County will transfer $23 million per year in gas tax revenues to the OCTA. This proposal will result in a net reduction in OCTA funding of $38 million in 1996-97 and $15 million annually thereafter through 2010-11. Depending on when the OCTA receives any portion of the $225 million repayment claim, the impact in future years might be offset by an unknown amount.

Based on our discussions with OCTA, the following is an illustration of the results that could occur if the $23 million in gas tax revenues are used for transit purposes, and the $15 million reduction is made in transit services.

$15 Million Reduction Could Result in Bus Service Decline.

- Overall service level (vehicle service hours)—reduction of about 10 percent on an average annual basis over the 15-year period. Reductions would be greater in the first few years and decline to around 5 percent in the last few years of the plan. This is because the growth in TDA funds (from local sales tax) over time will lessen the relative impact of the reduction.

- Ridership—Potential reduction of 10 percent on an average annual basis over the 15-year period, with the reduction also declining over time.

- Service area—Potential elimination of all service to the South County and Foothill areas. (These services are primarily commuter and express services.)

- Paratransit services (for seniors and disabled)—Potential limitation of availability to the area within 3/4 mile of the new reduced bus system—the minimum required by law. (Currently, funding of service levels exceed statutory requirements.)

- Service frequency, as well as bus fleet and staff, would also be reduced.

- A reduction in bus transit services could affect the area's compliance with air quality standards, although the impact and consequences cannot be estimated at this time.

- To the extend OCTA can defer capital expenditures or use other available reserves to backfill transit services, the impact of the fund reduction on transit may be reduced.

$23 Million for Transit Would Reduce Road Construction.

- County—The plan leaves sufficient gas tax revenues for the maintenance and operations of County roads. Funds for new construction, however, will be reduced by about $19 million annually beginning in 1997-98 (through 2010-11). Consequently, projects would be delayed. Alternatively, projects may compete for local funds under Measure M—Orange County's 1/2 cent sales tax for transportation, or state funds (in the State Transportation Improvement Program—STIP) through the Flexible Congestion Relief Program. The County may also raise funds via developer fees.

- Cities—Grant funds from Orange County for road projects will be reduced by about $3.5 million annually.

- Antonio Parkway—The plan leaves Orange County with $23 million of gas tax revenues (in 1996-97) for this project, which is estimated to cost about $40 million in total. The County will have to use future gas tax revenues or other funds to complete the project.

If OCTA is not able to use the $23 million for transit services, then transit services would likely be reduced to a much greater extent in order to deal with the $38 million annual deficit. At the same time, the OCTA will have $23 million more available for road construction.

Schools

No Further School Budget Reductions Expected at This Time. School districts have already recovered 90 percent of their investments in the County pool, and have absorbed their remaining $106 million in losses through work force reductions, spending reductions in the areas of instructional materials and maintenance, spending of reserve and, in rare instances, sales of property or issuance of certificates of participation.

The impact of the budget reductions necessary to accommodate this funding reduction was softened by two factors:

- Many districts had reserves that exceeded the state's minimum requirement.

- The 1995-96 state budget provides a significant increase in funding for K-14 education.

The Orange County Office of Education and the State Department of Education advise that no school district, at this point in time, appears unable to meet its operating budget for 1995-96.

Other Agencies

Flood Control Programs Reduced. The plan would reallocate less than 10 percent of annual revenues for flood control. The reallocation is unlikely to have any significant impact on construction of major County flood control projects, such as Santa Ana Mainstem. (The County's total share of cost of the Santa Ana project is $508 million, including $81 million that the state is to provide for work completed to date.) The reallocation may result in some potentially minor impact on the County's ability to fund capital improvements or maintenance for existing flood control facilities or acquire equipment or material for emergency flood control.

Harbors, Beaches and Parks Programs May Be Slightly Affected. The proposed reallocation is about 6 percent of annual revenues for these programs. There are no apparent public health or safety implications with the reallocation. Potential impacts include eliminating new park land acquisitions; eliminating new capital construction; reducing operations and maintenance; and increasing park entrance fees.

Impact on Cities and Special Districts. The recovery plan does not divert tax revenues from cities or non-County dependent special districts. Accordingly, the primary impact of the recovery plan on these local agencies is the risk that their remaining investment losses (generally 20 percent of their pool investments) will not be repaid. If the litigation is not successful, cities and special districts are likely to reduce future capital expenditures for roads and other public facilities. However, we do not expect major disruptions to programs or services due to the relatively strong financial condition of many Orange County cities and special districts.

Does the Recovery Plan Work?

While the recovery plan relies upon significant revenue diversions from other public entities and does not assure prompt payment of all bankruptcy claims against the County, the recovery plan does meet two very important objectives. Specifically, the plan:

- Fully repays all public debt, vendor and labor claims, and bankruptcy costs. This step will help restore investor confidence in Orange County and assist it in gaining access to investment markets in the future.

- Has obtained the conceptual support of representatives of most of the parties to the bankruptcy case. Agreement among the parties is an important factor in obtaining court approval of a settlement that will enable the County to emerge from bankruptcy.

Orange County's current and future fiscal health, however, remains a concern under the plan. As we discuss above, we have not been able to evaluate the County's ability to achieve its 1995-96 budget reductions while meeting its program requirements, nor have we been able to determine the extent to which current-year reductions will provide ongoing savings. Moreover, the plan requires the County to contribute additional amounts from its budget in future years. Finally, the County may face pressure to offset any revenue shortfalls that emerge if waste disposal or other recovery plan revenues are less than anticipated. Therefore, Orange County will remain vulnerable to fiscal threats from increased spending demands or revenue shortfalls for many years to come.

ADDENDUM A: WASTE DISPOSAL PROPOSAL

Details of Plan

The plan provides $15 million annually over the next 20 years from fee revenues—net of expenditures—generated by contracting for the disposal of out-of-county waste in Orange County landfills.

Viability and Impact of Plan

Revenue Projections Are Based on Contract Proposals. The plan's revenue projections are based on contract proposals from out-of-county waste haulers and governmental entities expressing interest in disposing of waste at Orange County landfills. The proposals contain bids which are effective until November 1, 1995.

The contract proposals would divert waste from current disposal at landfills in Los Angeles and San Diego Counties and Arizona. Most are for a duration of five, ten or ten-plus years, with a proposed disposal fee of between $14 and $24 per ton. The proposed fees are all lower than the current fee of $35 per ton charged for the disposal of waste from within Orange County.

Based on the contract proposals and using a higher disposal fee than proposed by potential contractors, the County's waste department projected net revenues from waste importation of $4 million in 1995-96, between $15 million and $22.5 million in 1996-97, and between $21.3 million and $27.8 million in each of 1997-98 through 1999-00. If the proposals are finalized, almost all of Orange County's landfill permitted capacity would be utilized on an annual basis within a few years.

Revenue Projections for Early Years Reasonable, But Still Subject to Some Uncertainty

Fee Levels. It appears likely that a majority of the contracts will be finalized. However, if the final negotiated fees are at lower-than-assumed levels, annual revenues would be lower than projected, by as much as $4 million beginning in 1997.

Availability of Prima Landfill. Actual revenues also depend on whether the Prima Landfill will be available to accept out-of-county waste. The City of San Juan Capistrano is pressing for the construction of a $45 million roadway (the Antonio Parkway) as a required measure to mitigate the environmental impact of the Prima Landfill accepting out-of-county waste. If current negotiations between San Juan Capistrano and Orange County fail, the Prima Landfill would not accept out-of-county waste, resulting in lower revenues.

$15 Million Annual Net Revenues Appear Reasonable by 1997-98. Given the contract proposals received by the County, it is reasonable to project annual net importation revenues of $15 million for 1997-98 through 1999-00. However, because of the uncertainty about fee levels for the imported waste and the availability of the

Prima Landfill, net revenues are unlikely to exceed $4 million in 1995-96 and could be as low as $11 million in 1996-97.

Revenue Projections More Uncertain After 2000. Because the contract proposals have terms varying from five to ten years, there is greater uncertainty in projecting revenues beyond the proposed contract expiration dates. For instance, it is not known how disposal fees in other counties will change over time, similarly, it is not known how the volume of waste will change in response to state mandates for waste reduction and diversion.

Impact on Other Jurisdictions. The current contract proposals would likely not have a major negative impact on Los Angeles and San Diego Counties because (1) a majority of the waste proposed to be diverted from Los Angeles County is from a City of Los Angeles landfill that the City is planning to close, and (2) a majority of the waste proposed to be diverted from San Diego County is already being diverted out-of-state to Arizona landfills.