

THE USE OF LEASE OR LEASE-PURCHASE ARRANGEMENTS
TO ACQUIRE STATE PRISONS

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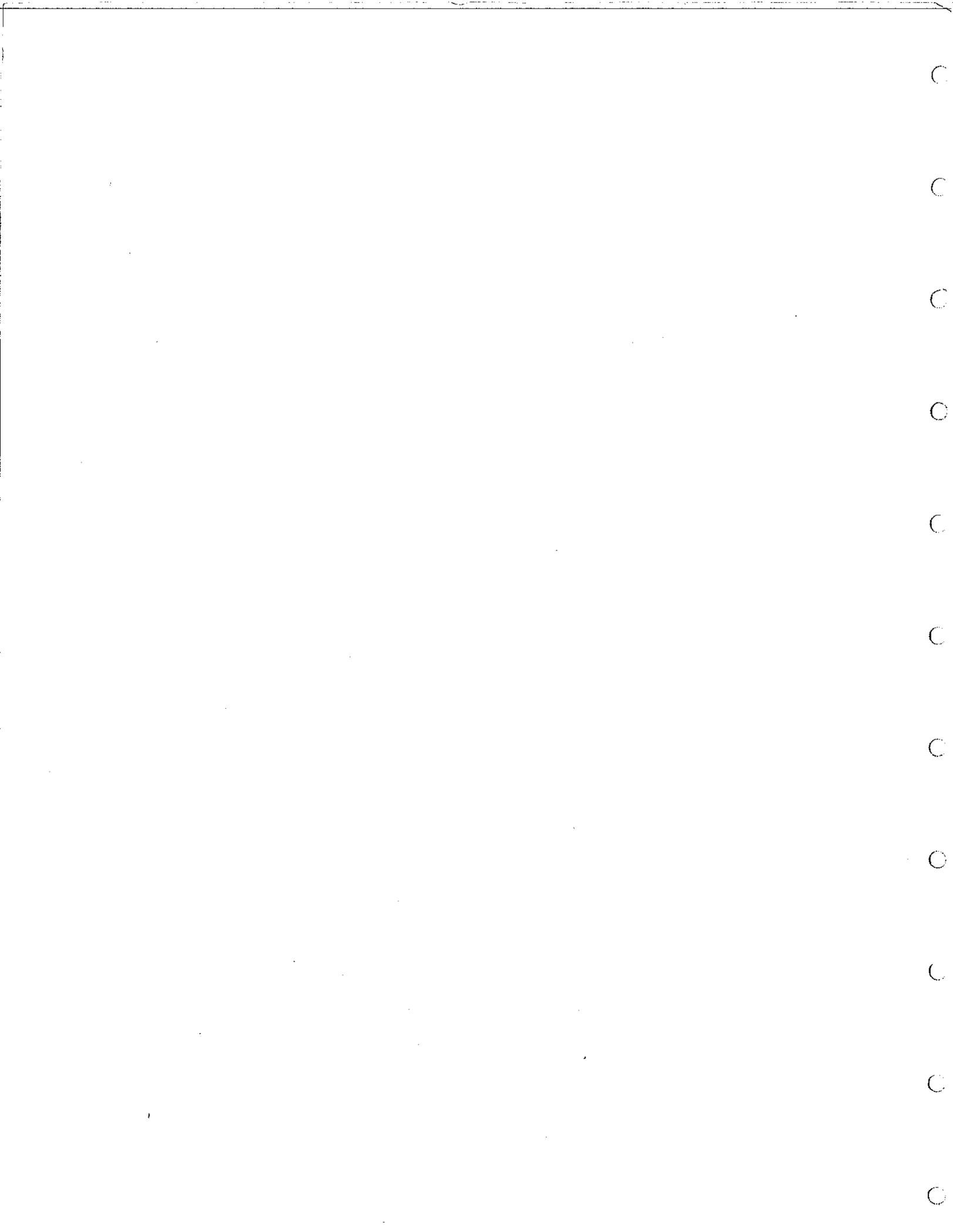


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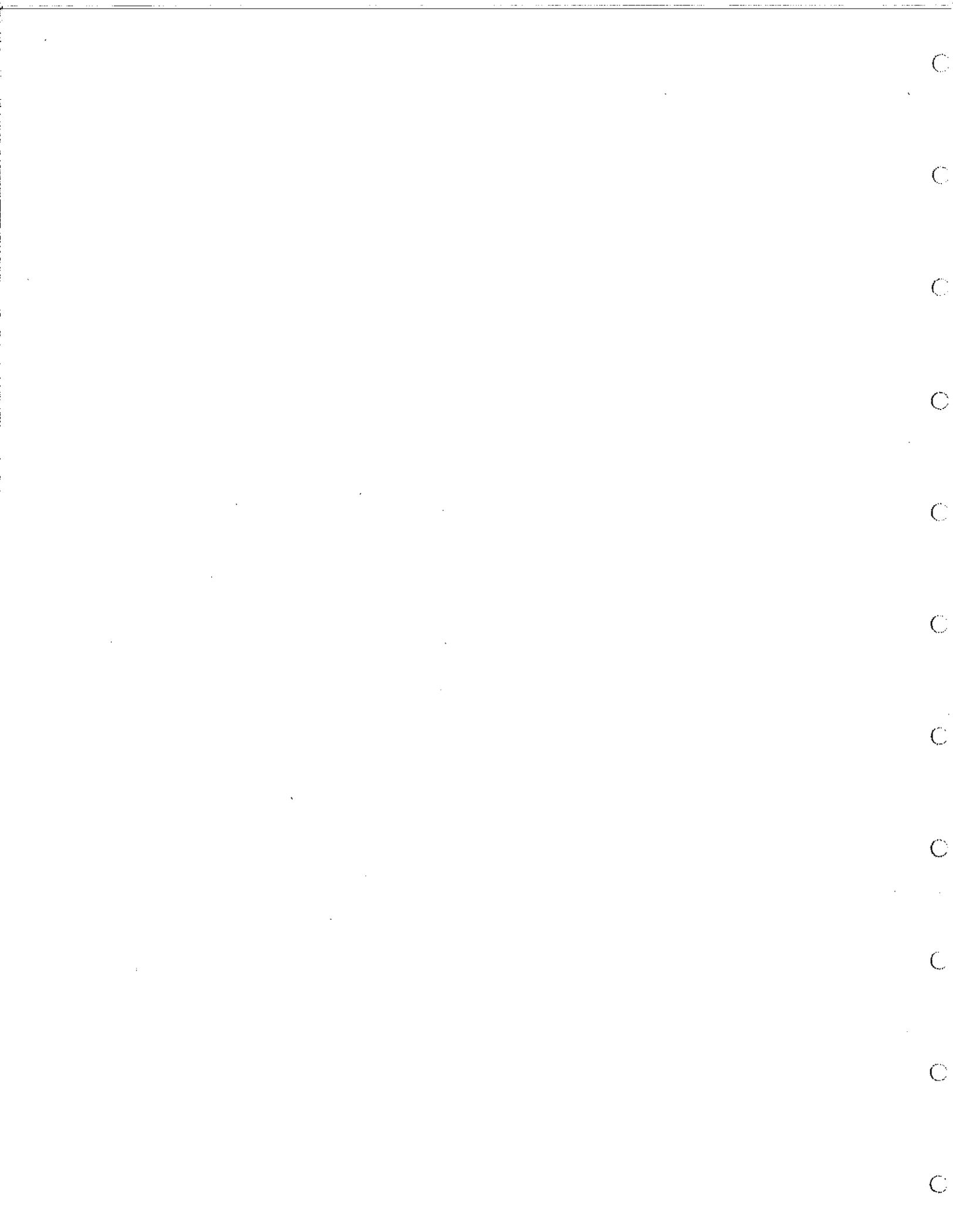
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INTRODUCTION

The State of California has a pressing need to provide more capacity to house inmates in the state's prison system. As of March 1984, there were 38,482 inmates in the prison system which has a design capacity for only 27,000 inmates. Moreover, the Department of Corrections expects the inmate population to increase to 52,345 by 1987.

The Legislature has taken steps to address this overcrowding by approving and partially funding 10 major prisons which will provide for 16,450 beds. In addition, the Legislature has appropriated funds for camps, modular buildings, and temporary facilities which will provide 4,250 beds. Once these new facilities have been completed and various temporary beds (such as tents) have been removed, the prison system will have a design capacity of 47,563 inmates. Even so, however, the capacity of the prison system will still be 10 percent less than the projected prison population of 52,345 inmates. Clearly, there is a pressing need for the state to acquire additional prison facilities.

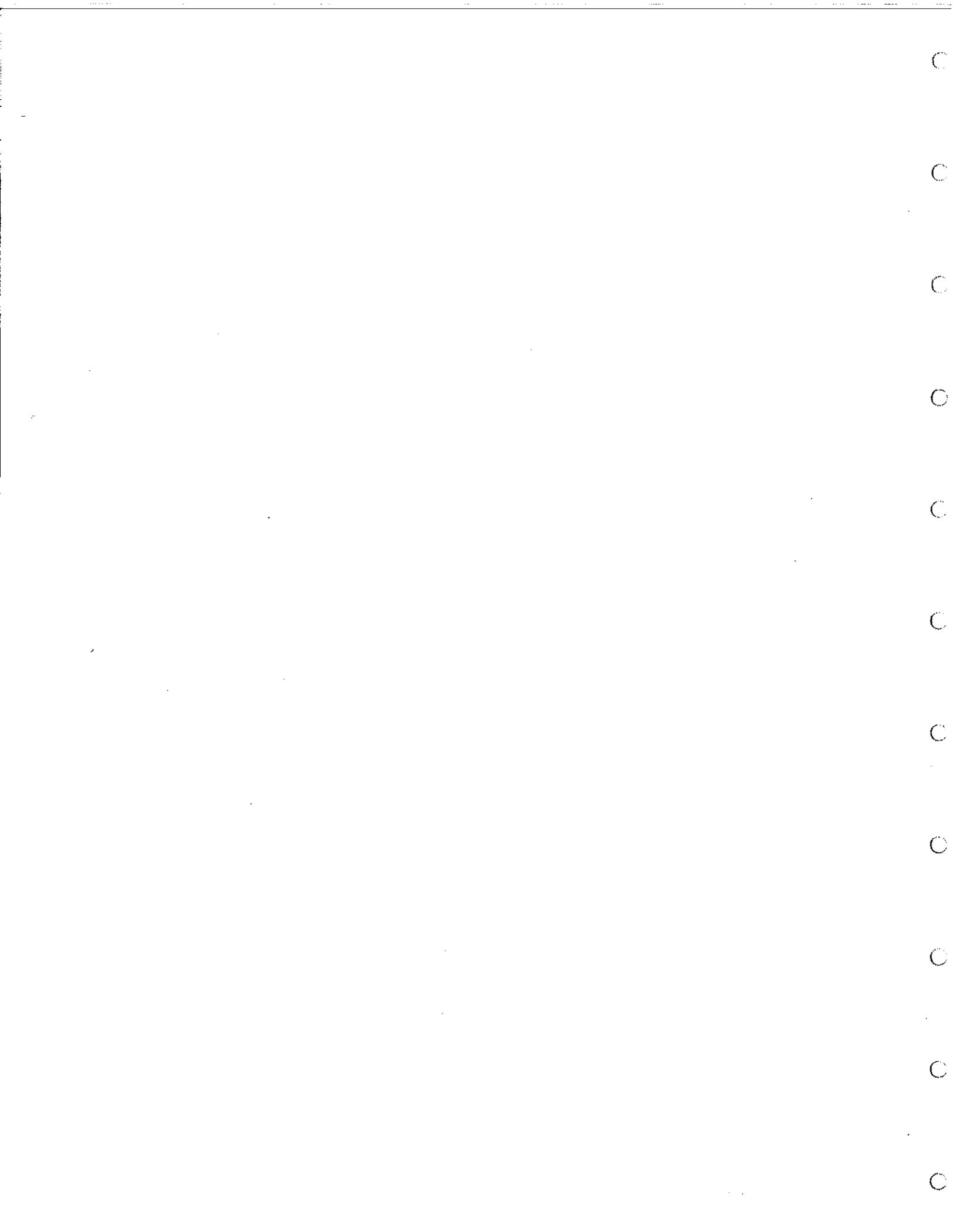
Based on the Department of Corrections' cost estimates, the balance of funds needed to complete the prison facilities already approved by the Legislature exceeds \$652 million. According to the department's February 24, 1984, report to the Legislature, there is a maximum of only \$28 million in the New Prison Construction Fund (monies from the proceeds of bond sales) available for completing those facilities which have already been approved. This leaves a balance of about \$625 million which must come from other sources.



To fund a part of this balance, the Governor's Budget for 1984-85 requests \$93 million from the General Fund. In addition, the Legislature has placed a \$300 million prison construction bond issue on the June 1984 ballot. If both of these funding proposals are approved, the unfunded balance needed to finance approved prison projects will be reduced to approximately \$232 million.

One option that has been suggested for closing this gap is to finance new prison construction using lease or lease-purchase arrangements. Senate Bill 422 (Ch 958/83) directs the Director of Corrections and the Legislative Analyst to investigate the advisability of using lease or lease-purchase arrangements to finance the acquisition of state prison facilities and to report their findings to the Legislature. The Director submitted his report in January 1984.

This report includes a brief discussion of the Director's report and summarizes our evaluation of various funding mechanisms that the Legislature could use to finance the acquisition of state prisons. The report was prepared by Gerald Beavers (Principal Capital Outlay Analyst) and Jon David Vasche (Senior Economist).



CHAPTER I

NEW PRISON CONSTRUCTION--FINANCING NEEDS AND ALTERNATIVES

This chapter presents an overview of new prison construction needs in the State of California, including (1) the scope of the state's existing prison construction program, (2) the financing which thus far has been made available by the Legislature to fund the construction program, and (3) the options available to the Legislature for securing the balance of funds needed to complete the program.

A. SCOPE OF THE PRISON CONSTRUCTION PROGRAM

As of March 1984, California's prison system had a design capacity for 27,000 inmates but was housing 38,142 inmates. Thus, occupancy of the system was 41 percent over capacity. The Department of Corrections expects the inmate population to reach 52,345 by June 30, 1987. This implies an average increase in the number of inmates equal to 455 each month.

In response to the need for additional inmate housing, the Legislature has approved funds for 10 major prisons (16,450 beds), as well as for various camps, modular buildings, and temporary space (4,250 beds), in order to increase the system's capacity to 47,700 beds. This capacity ultimately will be reduced to 47,563 because the department plans to eventually remove some temporary beds (such as tents). When all of these new beds are occupied in 1987, the prison system will still be overcrowded by approximately 10 percent. The overcrowding is expected to increase beyond 1987 because, according to the department's projections, the inmate population will continue to grow at the rate of about 200 inmates per month.

The department's 1984-85 new major prison plan indicates that a total of \$1,087 million will be needed to finance the additional 16,450 prison beds that have been approved to date. This \$1,087 million estimate is based on highly uncertain estimates of site acquisition and construction costs, and does not take into consideration the effect which inflation beyond July 1, 1984, will have on costs. Consequently, the eventual cost of acquiring facilities may vary significantly from the department's estimate. A summary of the department's proposal is shown in Table 1.

Table 1

Summary of Department of Corrections' Prison Construction Program for
1984-85

| <u>Location of Prison Facility</u> | <u>Bed Capacity of Facility</u> | <u>Estimated Total Cost</u> | <u>Prior Appropriations</u> | <u>1984-85 Proposed Budget Bill Appropriations</u> | <u>Additional Funds Needed To Complete Projects</u> |
|--|-------------------------------------|---------------------------------|---------------------------------|--|---|
| Tehachapi | 1,000 | \$94,987 | \$91,087 | \$3,900 | -- |
| Folsom | 1,700 | 164,679 | 127,379 | 37,300 | -- |
| Adelanto | 1,150 | 113,273 | 14,263 | 9,000 | \$89,650 |
| San Diego | 2,200 | 132,902 | 25,802 | -- | 107,100 |
| Riverside County | 1,700 | 101,100 | 12,900 | -- | 88,200 |
| Los Angeles | 1,700 | 115,300 | 8,700 | 18,400 | 88,200 |
| Vacaville | 2,400 | 124,800 | 79,800 | -- | 45,000 |
| Ione | 1,200 | 58,700 | 54,900 | 3,800 | -- |
| Avenal | 3,000 | 153,800 | 18,500 | 19,000 | 116,300 |
| Nor Cal Women's Facility | <u>400</u> | <u>27,000</u> | <u>700</u> | <u>1,400</u> | <u>24,900</u> |
| Totals | 16,450 | \$1,086,541 | \$443,929 | \$92,800 | \$559,350 |

B. FUNDS PRESENTLY AVAILABLE TO FINANCE THE PRISON CONSTRUCTION PROGRAM

A total of \$434 million has already been appropriated to fund the department's plan for prison expansion. The 1984-85 Budget Bill proposes that an additional \$93 million be appropriated from the General Fund, leaving a funding gap of \$559 million. According to the Department of Corrections, there is a balance of about \$28 million in the New Prison Construction Fund (bond proceeds). Taking these amounts into account, approximately \$532 million of additional funding would be needed to complete the department's 1984-85 plan.

To reduce the funding gap, the Legislature has placed on the June 1984 statewide ballot a measure authorizing the sale of \$300 million in new state prison general obligation bonds. Even if the proposed prison construction bond issue is approved by the electorate, however, the funding gap will still be about \$232 million. Therefore, at some point the Legislature will have to decide where the balance of money needed to complete the program will come from.

C. OPTIONS FOR SECURING THE BALANCE OF FUNDS

The Legislature has three basic options to "bridge the gap" between the total costs of the proposed prison construction program and the amount of financing for the program which has been made available to date. These options include direct appropriation for capital outlay expenditures, issuance of long-term general obligation bonds, and various types of lease-purchase arrangements.

1. Direct Capital Outlay Appropriation

This financing mechanism involves the direct appropriation of state monies to cover the full cost of the prison acquisition project. The

appropriation may be made from either the General Fund or a special fund established to fund capital outlay projects, such as the Special Account for Capital Outlay (SAFCO), into which state income from tidelands oil leases has been deposited. Because no funds are borrowed under this financing method, the capital outlay approach would require the smallest appropriation of funds to finance the development of a new prison.

2. General Obligation Bonds

Under this approach, the state raises the financial capital needed to acquire prisons by borrowing money in the private sector. It does so by selling long-term general obligation bonds to underwriters who then resell them to individuals and businesses. These bonds, which are secured by the full faith and credit of the state and pay interest which is exempt from state and federal income taxes, can be issued only with the approval of both the Legislature and the electorate. The State of California currently has 20 general obligation bond programs which fund capital outlay for such diverse purposes as higher education, parks, health facilities, water treatment, and county jail construction, in addition to state prison construction. The money which is borrowed by selling general obligation bonds is repaid, along with interest, over fairly long periods of time--generally 20 to 40 years.

3. Lease-Purchase Arrangements

Under this option, the state does not initially own the prison facility outright. Rather, it contracts to lease the facility, retaining the right to purchase the facility at some point in the future. Lease-purchase arrangements may be classified as either taxable or

tax-exempt. In the case of tax-exempt leases, the lease-purchase contract is technically viewed for tax purposes as an installment sale or conditional sales contract, and the interest portions of the lease payments to the property owner are classified as tax-exempt income. Since these partially tax-exempt lease payments are used to pay back investors who have contributed the up-front financial capital for prison construction, the tax exemption enables financing for the prison to be acquired at favorable interest rates.

There are many different methods by which state lease-purchase arrangements could be structured and financed. The most common of these methods include the following:

- Lease-Purchase Through a Joint Powers Authority. This approach involves two or more governmental entities joining together to build, own, and operate a facility. Financing is usually accomplished by selling tax-exempt bonds issued by the joint powers authority and secured by a long term lease.
- Lease-Purchase Using Certificates of Participation. This approach in essence involves what is called a tax-exempt real estate investment trust (REIT). Financial capital is raised by selling investment securities called "certificates of participation," which are essentially fractional interests or shares in lease contracts. The certificates of participation are treated like other municipal tax-exempt securities by the investment community. Under this approach, a lease-purchase agreement would be executed between the state and a nominal

lessor who holds title to the property in trust for the certificate holders throughout the lease term. At the end of the lease term, title to the property and the improvements on it passes to the state. For federal and state income tax purposes, the transaction is considered a conditional sale. Because of this, no tax benefits, such as depreciation, are available to the lessor, and the property is not subject to real estate taxes because the state is the buyer.

- Lease-Purchase Using Revenue Bonds. This financing method involves the sale of securities by nonprofit corporations created pursuant to the general nonprofit corporation law of the State of California. This approach is similar, in principle, to the joint powers authority approach, except that the interest earned by the holders of revenue bonds issued by nonprofit corporations is subject to California state (but not federal) income tax. Because the bonds are not exempt from state taxation, the interest rate on nonprofit corporation bonds is a bit higher than the interest rate on either general obligation bonds or certificates of participation.
- Lease-Purchase Through Conventional Financing. This approach involves the use of traditional mortgage funds obtained from private-sector sources such as insurance companies, pension funds, and savings and loan associations. Under this approach, the developer generally borrows 100 percent of the construction cost for a project, with the lease-purchase agreement as security

for the loan. Title to the property passes to the state free and clear at the end of the lease term. Because this transaction is considered a conditional sale for tax purposes, no depreciation or other ownership benefits are available to the lessor. The property, however, is not subject to real estate taxes, as the state is the buyer.

Our analysis of these different alternatives for financing acquisition of capital facilities, including prisons, is discussed in the following chapter.

CHAPTER II

ANALYSIS OF CAPITAL OUTLAY FINANCING ALTERNATIVES

This chapter analyzes the various capital outlay funding alternatives that are available to the state. We first discuss the criteria which should be used when evaluating financing alternatives, and then consider how each of these alternative financing methods fares when assessed using these criteria.

A. CRITERIA FOR EVALUATING CAPITAL OUTLAY FINANCING ALTERNATIVES

We believe that there are at least three general criteria which the Legislature should consider when determining how to finance the state's capital outlay projects.

The first criterion is cost. Here, we assume that the Legislature's objective is to minimize the cost of providing capital outlay facilities to the public, and therefore to lower the "price" (that is, the amount of taxes) which taxpayers must pay for these facilities and the services which they provide.

The second criterion involves how the costs of paying for capital outlay facilities are allocated, both over time and between different groups of taxpayers. This criterion includes the question of whether taxpayers who "pay" for capital outlay facilities should be the same taxpayers who benefit, either directly or indirectly, from the services these facilities generate.

The third criterion involves the issue of timeliness--that is, how much time is required to obtain financing for capital outlay expenditure purposes. Of special importance here is the question of whether a particular financing mechanism would result in unacceptably long time lags before a capital project could be "gotten off the ground."

In choosing among different capital outlay financing alternatives, the Legislature should consider how each alternative compares to the others in terms of these three factors--total cost, allocation of costs, and timeliness. Of course, some financing alternatives may score well on one criterion but not so well on another. For example, one alternative may result in lower costs, but at the same time may do a poor job of matching the tax burdens necessary to fund the project with the taxpayers who will benefit from the project.

Consequently, merely comparing the alternatives using these criteria is not enough. The Legislature will also have to determine how important each criterion--cost, allocation, and timeliness--is, and thus how heavily each should be weighted. Regardless of how this weighting is done, however, what is important is that each criterion be considered before a specific capital outlay financing alternative is selected.

The three criteria used to evaluate alternative financing mechanisms are discussed in greater detail below.

B. THE COST OF ALTERNATIVE FINANCING METHODS

In order to evaluate what the least costly financing alternative is for a capital outlay project, it is necessary to identify and measure the various cost components characteristic of each type of financing. These cost components fall into four general areas:

- First, there is the actual value of the capital project which has to be financed. In the case of a prison, this would be the site cost and construction cost, which can exceed \$100 million;
- Second, there is the cost of arranging financing. For example, if a project is to be financed by issuing bonds, there are various fees which must be paid by the bond issuer to the bond underwriters;
- Third, if financing is secured by some means other than direct appropriation of funds, there are basic interest costs which must be paid to investors for the use of their funds; and
- Fourth, depending on the type of project involved and the financing mechanism used, investors may demand risk premiums above and beyond normal interest rates in order to induce them to put up the financial capital needed to fund the project.

These cost factors are discussed below as they apply to various capital outlay financing alternatives. First, however, it is necessary to discuss an adjustment which must be made to the estimated costs of alternative financing approaches in order to make valid comparisons of these costs. This adjustment involves the concept of present value.

1. The Concept of Present Value

The concept of present value is based on the fact that one's view on what a dollar is "worth" depends on when one expects to receive it. For example, if a person is given the choice between receiving \$100 today or \$100 one year from now, the preferred choice would be to have the \$100 today, even if the person has no immediate use for the money. There are

several reasons for placing more value on funds that become available sooner rather than later. These include the tendency of inflation to reduce purchasing power over time, uncertainty regarding the future, and the fact that funds available today can be invested in order to earn interest. For these reasons, the value in today's terms--that is, the present value--of \$100 to be received one year from now is clearly less than \$100. Reducing this \$100 to what it is worth today is called discounting. For example, if we would just as soon have \$90 today as \$100 one year from now, the "discount rate" is said to be 10 percent per year.

The concepts of present value and discounting are extremely important to consider when comparing the costs of alternative capital outlay funding approaches. This is because the state's payments for capital outlay projects under alternative financing approaches occur at different points in time. Therefore, it can easily be the case that two financing alternatives with equal dollar costs do not have the same present value cost, because the timing of payments is different. Specifically, the longer the state can postpone a given cost, the greater the cost is discounted and the less it becomes in present value terms. The difference between dollar costs and present value costs becomes especially significant over lengthy time periods, such as those characterizing the lifespans of capital outlay facilities and the periods over which bonds are paid off.

Given the above, it is important that the costs associated with each alternative capital outlay financing method be converted into present value terms, so that all of the alternatives can be properly compared to one another.

2. Cost Components

As noted earlier, there are four basic cost factors to account for when comparing capital outlay financing alternatives--initial project cost, cost of arranging financing, basic interest costs, and special risk premiums. To assess the costs of alternative financing for any given capital project of specified characteristics (such as a prison), we assume that the first cost component--initial project cost--is the same under each financing alternative (the separate effect of financing delays on project costs is discussed in Section D, below). Our discussion thus focuses on the latter three cost elements.

a. Costs of Arranging Financing

Under the direct appropriation alternative, no costs are incurred to arrange financing since there is no financing to be arranged. Funds for capital outlay are simply appropriated by the Legislature.

The other financing alternatives, however, do involve costs associated with arranging financing. In the case of general obligation bond sales, a variety of underwriting costs must be paid for various legal and marketing services provided by investment bankers, attorneys and other parties involved in the underwriting process. In the case of lease-purchase financing arrangements, there are also underwriting-related costs which must be paid, even if a state entity, such as the State Public Works Board, is selected to arrange financing. Of course, the state need not always pay such costs directly, because the securities used to raise the financial capital for lease-purchase projects may also be issued by a third party. For example, it is not uncommon under the lease-purchase

approach for a financial intermediary (such as a leasing company or a securities firm) to arrange for certificates of participation to be issued to either individuals or, more commonly in the case of large projects, institutional investors (like banks and insurance companies). The financial intermediary generally contracts with a specific bank to execute the certificates of participation and, in many cases, to act as trustee or escrow agent, receiving the lease payments from the governmental lessee and distributing them to the participating investors. In this type of arrangement, the costs for arranging financing may not be paid for directly by the governmental entity. However, because the lease payments themselves are structured to fully cover the costs of borrowing, these arrangement costs eventually will be paid for indirectly through the lease payments. Thus, regardless of whether financial arrangement costs are paid directly or indirectly, the state will incur these costs under either bond financing or lease-purchase financing.

The magnitude of costs will depend on a variety of factors, including the financing requirements for a project, whether the securities involved are marketed using competitive-bid versus negotiated underwriting, whether the securities are publicly offered to investors or privately placed, what secures the securities, whether insurance is purchased, and the specific characteristics of the project involved since this affects the general marketability of the securities. In the case of general obligation bonds, most studies suggest that gross underwriting spreads (that is, underwriting costs as a percent of the amount of financial capital raised) range from about 1½ percent to 3 percent, with the spread declining as an

issue's size rises since certain costs are relatively fixed. In the case of lease-purchase financing, our information on costs is much less complete, since this tool has been used less extensively than bond financing, especially for extremely large capital facilities projects with long lifespans such as prisons. However, existing studies have indicated that putting together a large publicly offered (as opposed to privately placed) certificate-of-participation lease is a complex undertaking, and therefore it can be expected to carry with it significant financial arrangement costs. The Department of General Services has found that because of underwriting and legal expenses, the issuance of publicly offered certificates of participation is recommended only for large projects or pools of smaller projects.

A recent experience with state certificate-of-participation lease-purchase financing in California involved the new Franchise Tax Board (FTB) building. The underwriting fees assessed for selling certificates of participation in this project amounted to 3 percent (\$1.26 million) of the volume of securities issued (\$42.1 million). Thus, underwriting costs for this project were at the higher end of the range for bond underwriting fees. However, additional costs were also incurred to arrange financing for the FTB building. Specifically, there were \$325,000 in other miscellaneous costs for payments to such parties as legal counsel and a title insurance company, and \$767,230 in costs for bond insurance to protect investors in the event of default. These three cost components--the underwriting discount, miscellaneous fees, and insurance costs--thus amounted to nearly \$2.4 million, or 5.6 percent of the

securities sold. This amount is well above the cost that normally would be incurred in arranging a general obligation bond sale, since insurance is not purchased for these bonds. When certificates are sold, however, such insurance normally is bought in order to improve the securities' ratings and thereby reduce the interest rates at which they can be marketed. For this reason, we believe that the total costs for arranging financing for large certificate of participation lease-purchase deals could, at least in certain circumstances, be considerably higher than the cost of arranging traditional bond financing.

b. Basic Interest Costs and Risk Premiums

General background. Interest costs and risk premiums are appropriately discussed together since they both "show up" in the interest rates which must be paid when capital outlay financing requires the use of borrowed money. Naturally, direct appropriation of funds for capital outlay incurs no interest costs or risk payments, since no borrowing is required. However, when financing is accomplished using either bond sales or lease-purchase arrangements combined with sales of participation certificates or other securities, interest costs and risk premiums are a critical cost element.

The interest rate which must be paid on borrowed funds depends on two factors. The first factor is the "basic" interest rate which investors require when there is little or no risk that they will not be repaid. This rate is determined primarily by the rate of inflation and the underlying productivity of capital expected in the economy over the period for which the funds are borrowed. The second factor affecting interest rates is the

risks which investors feel they "take on" when they loan money. These risks must be compensated for by the addition of "risk premiums" to the "basic" or risk-free interest rate. The risk premiums paid on borrowing will differ, depending on the type of project being financed and the type of security which is pledged to protect the investors' money. As a result, the total interest costs of borrowing will vary, depending on the purposes for which the money is used and what type of guarantees are made that the borrowed funds will be repaid in a timely fashion.

Interest Costs for Different Financing Alternatives. Under most circumstances, the lowest interest rate at which the state can borrow money is the interest rate on state-issued general obligation bonds. This is because general obligation bonds entail minimal risk for investors, especially since the state's entire \$26 billion revenue base stands behind them. Other forms of borrowing usually require somewhat higher interest rates, since they either offer less security or do not provide investors with comparable tax advantages. This is generally true in the case of the lease-purchase financing tools described in Chapter I. For example:

- Lease-purchase financed through a joint powers authority involves the issuance of tax-exempt revenue bonds secured by a long-term lease that is dependent on an annual appropriation, and not by the state's general tax base.
- Lease-purchase financed through revenue bonds issued by a nonprofit corporation not only has the drawback of being secured by a lease rather than the general tax base; it also must further compensate investors because the interest on the bonds is not exempt from taxation under California laws.

- Lease-purchase arrangements using certificates of participation are, in the opinion of bond counsels, presently exempt from both federal and state income taxes. However, this approach also generally relies on a lease for security, rather than on the tax base or other revenue sources.
- Lease-purchase using conventional financing provides interest to investors that is not exempt from taxation under either state or federal law. Because of this, a significant interest premium must be paid to these investors, relative to the interest that can be offered on tax-exempt securities. As a result, the amortization cost of a conventional loan--and thus the associated lease payments--are correspondingly higher than when tax-exempt financing is used.

The interest rates that must be offered in connection with tax-exempt lease-purchase arrangements secured by lease payments are likely to be a bit higher than the interest rates on other tax-exempt obligations of similar maturity length and other characteristics. This is generally because such lease arrangements typically contain "nonappropriation" language, which enables the state or local government to avoid lease payment obligations beyond its current fiscal period. Such language is needed to establish that the lease technically does not constitute indebtedness on the government's part, and therefore is not subject to the voters' approval or statutory borrowing restrictions involving such topics as maximum-allowable interest rates. The inclusion of nonappropriation language, however, automatically imposes risks on investors for which they must be compensated through higher interest yields.

The degree of risk that investors associate with "nonappropriation" clauses will be determined primarily by two factors--first, the likelihood that the governmental lessee will continue to use the capital facility in the future, and second, the extent to which the facility could be shifted to some alternative use and yield an economically desirable return in the event the governmental lessee terminates the lease. Investors are in the best position to evaluate the latter factor.

It is likely that investors will perceive the risk of leasing to the government an office building in the middle of a populated area as being much less than the risks associated with leasing a prison structure located in a more remote area. This would tend to raise the interest costs of certificate-of-participation financing, and thus the amount of government lease payments, for a prison facility relative to an office building facility. Of course, the risks to investors under certificate-financed lease-purchase arrangements can be offset by the purchase of certificate insurance that guarantees principal and interest payments, as was done for the FTB project. This insurance, which is provided through the American Municipal Bond Assurance Corporation, extends for the life of the certificates, cannot be cancelled, and resulted in raising the rating on the certificates to the highest level possible--"AAA"--by Standard and Poor's. However, while such insurance can bring the interest rates demanded by investors down to a level roughly equivalent to general obligation bonds, the insurance involves costs which the government must either directly or indirectly pay.

There is, however, one factor which some have argued can give certificate-of-participation financing secured by leases an interest cost advantage over general obligation bonds. This factor, which is discussed below, involves the income which financial capital raised through borrowing can earn prior to when it is needed.

The Effect of Investment Income on Net Interest Costs. If some or all of the financial capital obtained by borrowing is collected in advance of when it is needed to actually fund a capital outlay project, the funds can be invested so as to earn interest. If the rate of interest earned on these funds exceeds the interest rate charged for the funds, the net interest cost of borrowing can be reduced.

This often happens when funds are borrowed by issuing tax-exempt securities, such as general obligation bonds and certificates of participation, since the funds can be invested in taxable securities which pay higher interest yields than do tax-exempt securities. The profits generated by the "spread" between the taxable and tax-exempt interest rates are referred to as net reinvestment "arbitrage" earnings. Although the Internal Revenue Service enforces a variety of rules and regulations to restrict such earnings, a certain amount can be earned without jeopardizing the tax-exempt status of the securities themselves.

These are two reasons why certificate-of-participation financing is especially likely to produce arbitrage interest earnings:

- First, most certificate of participation financing packages for lease-purchase agreements provide for the establishment of a reserve fund. This reserve, which is funded from the proceeds of

certificate sales, is intended to ensure that investors will receive timely lease payments should the lessee be late in making the payments. Thus, the reserve fund guarantees a steady cash flow to investors in the short run. (Naturally, such a reserve cannot protect investors if there is a lengthy period during which lease payments are not made or when the lessee defaults altogether and a new lessee cannot be found. To protect against these situations, investors would have to purchase bond insurance for the certificates, which guarantees the payment of both principal and interest.) In addition, however, the balance in the reserve fund can also be "put to work" earning interest on higher-yielding, taxable securities. Such reserves, and thus the income they generate, do not exist when general obligation bonds are used. For the FTB certificate of participation project cited earlier, the reserve fund amounts to over \$4.5 million, or nearly 11 percent of the amount raised to fund the costs of land, construction, and arranging financing.

- Second, in practice, it appears that a higher proportion of the financial capital raised through the issuance of participation certificates tends to be collected further in advance of when it is to be spent than is true in the case of general obligation bond financing. One reason for this is that projects for which the electorate has approved general obligation bonds can be started before the bonds are sold, using an advance of funds from the State Treasury. This permits the sale of the bonds

themselves at a later date, which is sometimes done. Another reason is simply that the State Treasurer has a policy of generally not selling bonds much in advance of actual cash needs for projects. As a result, even though the Internal Revenue Service permits general obligation bond monies raised to finance projects the same opportunity as certificates to accumulate arbitrage interest earnings, in practice the magnitude of these earnings tends to be much greater when certificate-of-participation financing is used.

Both of these factors result in the accumulation of arbitrage interest earnings which help to lower the total costs at which projects can be financed through the sale of certificates of participation. In the case of the FTB project, the value of the interest earnings projected for the three years prior to when the FTB building will be ready for occupancy amounts to over \$4.3 million (this assumes an interest yield of 8 percent per annum), which enabled the amount of actual borrowing needed to finance the project to drop from \$46.4 million to \$42.1 million. As noted above, part of this investment income--that derived from the reserve fund balance--would not be available under general obligation bond financing. However, general obligation bond financing does have the potential to derive those investment benefits associated with maximizing the time period over which unused bond monies can be invested in higher-yielding taxable securities.

3. Which Financing Method is "Least Costly"?

As discussed earlier, the "least costly" alternative for financing capital outlay projects is found by summing up the cost factors listed above for each alternative and expressing the total in present value terms by applying an appropriate discount rate.

There is no question that, in terms of the amount that must be appropriated to acquire a prison, the direct appropriation financing mechanism is the least costly. This alternative, however, may not be the "least costly" alternative in the economic sense. This is because the cost of acquiring a capital facility is based not only on how many dollars must be spent, but also on when the dollars are spent. It is also based on how the interest rate paid on borrowed funds compares to the rate of inflation expected in the future and the alternative benefits that could be realized if the appropriated funds were shifted into some other use.

When the costs associated with each of the various financing alternatives are expressed in present value terms, it becomes clear that the costs of financing capital outlay projects through borrowing and lease-purchase arrangements are much lower than when payments on the borrowed funds or lease payments are merely summed without regard to when they occur. In fact, if the discount rate used to express these costs in present value terms is high enough, alternatives that rely on borrowing and lease-purchase can actually be "less costly" in the economic sense than direct appropriations. Obviously, the key step in making these comparisons is selecting an appropriate discount rate. This is because the present value of a stream of capital outlay payments in future years, and thus the financing alternative found to be "least costly," is very sensitive to the discount rate used.

Findings of the Department of General Services' Study. In November 1983, the Department of General Services published a report comparing the cost of alternative capital outlay funding approaches. The department's study first identified the various cost elements of different financing alternatives, by year, and then converted the total cost figure for each alternative into present value terms. The capital facility used in its study was an office building.

The department used as the discount rate the interest yield on the Pooled Money Investment Account (PMIA), on the grounds that this is the return which state funds would earn if, instead of being used for capital outlay purposes, they were invested. By using the PMIA yield as the discount rate, the department generally concludes that:

- General obligation bonds are the cheapest means of financing the acquisition of capital facilities through borrowing, followed by certificates of participation and Public Works Board building certificates, and
- All three of these borrowing mechanisms offer a less costly means of financing than direct appropriations.

The department's overall ranking of the financing alternatives it considered is shown in Table 2, in ascending order from lowest present value cost to highest present value cost.

Table 2
 Ranking of Financing Costs for Alternative
 Capital Outlay Financing Methods^a

| <u>Rank</u> | <u>Financing Alternative</u> |
|-------------|--|
| 1 | General Obligation Bonds |
| 2 | Certificates of Participation |
| 3 | Public Works Board Building Certificates |
| 4 | Direct Appropriation of General Fund or Special Funds Monies |
| 5 | Public Works Board Revenue Bonds and Joint Powers Authority Financing |
| 6 | Financing Through NonProfit Corporations |
| 7 | Straightforward Lease with Option to Purchase Arrangements |
| 8 | Conventional Financing |
| 9 | Straightforward Leasing |

a. Source: State of California Financing Alternatives, Department of General Services, State and Consumer Services Agency, November 1983. One of the financing alternatives reviewed by the department--leveraged leasing--is not shown in Table 2 because its costs depend upon certain federal tax law provisions which, at the time the study was made, were still being reviewed by Congress.

Other Rankings Are Possible. The department acknowledges that its general finding--that financing capital outlay projects with borrowed funds

is cheaper than using direct appropriations--stems directly from the fact that the discount rate used by the department (the PMIA yield, which was around 10½ percent when the department's report was prepared) exceeds the state's cost of borrowing in the tax-exempt securities markets (around 9 percent for 20-year maturity bonds). In other words, the department's rankings reflect the assumption that if the state has funds available for appropriation, the rate of return it can earn either by investing these funds in the PMIA or using them for some purpose other than capital outlay financing, is greater than the interest rate on borrowing. Given this assumption, it always "makes sense" to borrow. The department also acknowledges, however, that the rankings of financing alternatives shown in Table 2 could change if a different discount rate assumption is used.

In our view, there is no analytically "right" discount rate. The selection of a discount rate is a policy decision that can only be made by the Legislature, since only the Legislature can decide what one dollar paid a year from now is worth today. In making this decision, the Legislature could choose from among many different discount rates. If, for example, the Legislature decided that all monies available to directly fund capital outlay projects but not used for this purpose should be put into and retained by the PMIA, the PMIA yield would be the appropriate discount rate to use in comparing financing alternatives. If, however, the Legislature decides that these funds otherwise would be used in some alternative manner, then a different discount rate might be applicable. In any event, it is likely that the "least costly" means of financing capital outlay will vary over time, depending in part upon the state's general budget position

and the Legislature's views about the relative benefits from spending state revenues in different ways.

Cases Where Borrowing is Preferable. Financing capital outlay projects through borrowing will tend to be the "least costly" alternative when the Legislature concludes that using available funds to support the provision of public services now is an extremely high priority. This is likely to be the case whenever the state's fiscal condition is very tight, and state services have had to be reduced for budget-balancing purposes. Under these conditions, the Legislature probably will find it advantageous to finance capital projects through borrowing in order to "free up" scarce resources that can be used to maintain current services. Of course, it should be remembered that borrowing entails certain burdens. For example, once funds for capital outlay are borrowed, they must be repaid according to a specified timetable. This can, in its own way, reduce the Legislature's flexibility in making budget decisions. In the case of California, however, the practical significance of this factor is limited since the state's annual debt-servicing costs are a relatively small component of the total state budget.

Cases Where Direct Appropriation is Preferable. Financing capital outlay projects through direct appropriations will be viewed by the Legislature as being the "least costly" alternative when the investment of state funds earns less than the cost of borrowing, or when costs and payments in the future take on a relatively greater importance. This might be the case when there is a large budget surplus, as there was in the late 1970s. Under these conditions, the Legislature may feel that direct

appropriations for capital outlay makes a great deal of sense since there is little need to "free up" additional monies to support state programs, and in fact one-time appropriations for capital outlay can prevent future-year budgets from becoming overcommitted.

4. Summary

Our principal findings regarding the costs of alternative financing approaches are as follows:

- a. There is no definitive answer to the question of whether it is less costly to finance the acquisition of capital facilities through direct appropriations or through borrowing. This is because changes in the state's fiscal condition can change the Legislature's assessment of what is being "given up" when funds are directly appropriated for capital outlay spending. When the value of what is being "given up" is considered to be high, as may be the case when the budget is "tight", the factor used to discount debt service payments in the future will also be high, making borrowing "less costly". In contrast, when the value of what is being "given up" is low, as may be the case when large budget surpluses exist, the discount factor will also be low and direct appropriations may turn out to be "less costly".
- b. In cases where borrowing is determined by the Legislature to be preferable, the cost of doing so through the (indirect) sale of securities such as certificates of participation, may or may not be lower than the cost of selling bonds. Which method is less costly will depend on such factors as the costs incurred in

preparing, marketing, and managing each form of financing, the way in which the certificates are secured, and the extent to which the financial capital obtained under each approach can be collected in advance of its actual spending, thereby allowing it to be invested temporarily in higher-yielding securities.

Strictly on the basis of cost, we conclude that the sale of general obligation bonds is the preferable form of borrowing, at least in the majority of (although not necessarily all) cases when the state must finance large state capital outlay projects. There are several reasons for this:

- First, there is no hard data to our knowledge to indicate that when the amount of money to be raised is large, the costs of underwriting and marketing certificates of participation are less than what they are for tax-exempt bonds, and there is some limited evidence that the reverse is true. Tax-exempt bonds are especially likely to have cost advantage over certificates of participation when (1) insurance must be purchased to make the certificates highly marketable, and (2) the cost of the projects to be financed is particularly large. Under the latter circumstance, the costs involved in underwriting and marketing large conventional general obligation bond issues can be "spread over" a very large base.
- Second, in the case of projects that have relatively few alternative uses or users the risks that must be assumed by an investor whose investment is secured only by a lease containing a

"nonappropriation" clause can be significant. These risks, which are not faced by investors purchasing general obligation bonds, must be compensated through a higher interest rate or offset through the purchase of insurance. (Where a project has a number of alternative uses--for example, an office building--the risks associated with lease-purchase financing are much less.)

Illustrative Cost Comparison

It is difficult to provide a meaningful quantitative comparison of the costs involved in using general obligation bond financing and certificate-of-participation lease-purchase financing. This is because many different factors can affect financing costs. It is possible, however, to provide a general indication of what the cost differences between each alternative might be. In doing this, we will focus on three of the key cost-related factors identified earlier--underwriting fees, insurance costs, and reinvestment earnings on reserve balances.

Table 3 shows the costs associated with these factors on a \$100 million sale of securities, under various assumptions. Specifically, we assume that underwriting fees range from 1.5 percent to 3.0 percent of the volume of securities issued, that insurance premium costs range from 1 percent to 2 percent of the volume of securities issued, and that the gap between the interest paid on invested reserve balance funds and the cost of borrowing these funds (that is, the net yield on reserve monies) ranges from 1 percent to 3 percent.

Table 3 indicates that for a \$100 million certificate-of-participation issue with 30-year maturity, underwriting fees of 3 percent

(\$3 million), insurance premium costs of 2 percent (\$2 million), and a net yield on invested reserve account funds of 2 percent (about \$2 million), the total cost attributable to these three factors would be about \$3 million. A different set of assumptions, of course, would produce a different cost estimate for certificate sales.

In the case of state general obligation bonds, only the underwriting fee in Table 3 needs to be taken into account, since these bonds do not need insurance nor do they have a reserve balance account.

Table 3

Fiscal Effects of Alternative Assumptions Regarding
Underwriting Fees, Insurance Premium
Costs and Reinvestment Yields

Fiscal Effect in Present Value
Terms, Assuming Sale of
\$100 Million of Securities
(dollars in thousands)

| | | |
|---|--|--|
| 1. <u>Underwriting Fees (one-time)</u> | | |
| a. | 1.5% of value of securities issued | \$1,500 |
| b. | 2.0% of value of securities issued | 2,000 |
| c. | 2.5% of value of securities issued | 2,500 |
| d. | 3.0% of value of securities issued | 3,000 |
| 2. <u>Insurance Premium Costs (one-time)^a</u> | | |
| a. | 1.0% of value of securities issued | \$1,000 |
| b. | 1.5% of value of securities issued | 1,500 |
| c. | 1.8% of value of securities issued | 1,800 |
| d. | 2.0% of value of securities issued | 2,000 |
| 3. <u>Net Yield on Invested Reserve Funds^b</u> | | |
| | <u>20-year</u> <u>Maturity Length^c</u> | <u>30-year</u> <u>Maturity Length^c</u> |
| a. | 1.0% per annum | \$ 915 |
| b. | 1.5% per annum | 1,372 |
| c. | 2.0% per annum | 1,829 |
| d. | 2.5% per annum | 2,287 |
| e. | 3.0% per annum | 2,744 |

a. The costs of purchasing private municipal bond guarantees are computed in different ways by each of the two major insurance providers. For example, the American Municipal Bond Assurance Corporation's fees range from about 1/4% to 1 1/4% of original bond principal and interest in the case of general obligation bonds and revenue bonds of existing facilities, whereas the Municipal Bond Insurance Corporation's fees range from 1% to 2% of original principal in the case of general obligation bonds and utility revenue bonds. See M. Joehnk and D. Kidwell, "Determining the Advantages and Disadvantages of Private Municipal Bond Guarantees" in J. Peterson and W. Haugh, ed., Creative Capital Financing For State and Local Governments, Municipal Finance Officers Association, 1983, pp. 193-223.

b. These net yield margins represent the differential between the interest rates at which reserve funds can be invested and at which reserve funds have been borrowed.

c. Represents maturity length of longest-maturity security in a package of serial bonds or certificates of differing maturities. Computed reinvestment earnings are based on a reserve equal to 10.7 percent of the bond issue. This is the size of the reserve fund established for the FTB project, and is based upon the federal rule that a reserve needed to make securities marketable can be up to 15 percent of actual direct project costs for site and facility acquisition without violating arbitrage restrictions. Reinvestment returns have been converted to present value terms using an annual discount rate of 10 percent.

As shown in the table, the costs of certificate financing could be greater than, about equal to, or less than the costs of general obligation bond financing, depending on the specific assumptions made. For example, if underwriting fees are similar for the two financing alternatives but insurance premium costs for certificates are low, net reinvestment yields of reserve balances are high, and a lengthy maturity structure is assumed, certificate financing could be least costly. (This assumes that the purchase of insurance enables the interest rates on certificates to equal those on bonds.) On the other hand, if certificate insurance premium costs are higher and net reinvestment yields are lower, bond financing will be least costly, even if underwriting fees and interest rates for the two types of securities are equivalent.

When we assess the likelihood of various alternative assumptions being borne out, we conclude that, in most cases, bond financing would be the least costly alternative. For example, the FTB certificate-financed project paid an insurance premium on the high end of the scale--1.8 percent. Likewise, the longest-maturity certificates (20 years) on the FTB project (which can be viewed as funding the reserve account since the reserve account must be maintained until the investors are paid off) carried an interest rate of 9 percent compared to a PMIA investment yield of about 10.5 percent in mid-1983, implying a net reinvestment reserve balance yield at the lower end of the scale shown in the table--about 1.5 percent. The data in Table 1 indicate that if these rates were typical of certificate financing, the cost of a \$100 million issue with respect to these three factors would exceed the costs of general obligation bond

financing by about \$428,000. This assumes that underwriting fees for the two types of financing would be equal. If underwriting fees were not equal and instead general obligation underwriting fees were less, certificate financing costs would be an additional \$500,000 higher for each $\frac{1}{2}$ percentage point differential in the underwriting fee. This example shows why, strictly on the basis of cost, we believe that the sale of general obligation bonds will turn out to be the preferable form of borrowing, at least in the majority (though not necessarily all) cases when large state capital outlay projects must be financed.

Other Considerations

Proponents of lease-purchase financing argue that various marketing features can significantly reduce interest rates on securities typically used in connection with tax-exempt lease-purchase financing, including revenue bonds and certificates of participation. Some have even argued that it may even be possible to reduce the interest rate on certificates below the rate for general obligation bonds. These marketing features include "put options" and "variable" (or "floating") interest rates.

While special marketing devices may, indeed, reduce the interest rate that lenders will demand, we do not believe that the use of these devices would necessarily give lease-purchase financing techniques an absolute cost advantage over general obligation bond sales, for two reasons.

First, while these marketing features may reduce the initial "up-front" interest costs on securities, they will also force the state to assume the risk of higher interest costs in the future. Thus, it is not

clear that such features would necessarily make the costs of financing capital projects through lease-purchase arrangements truly "lower."

Second, and more importantly, there is no reason why such special marketing devices, if found to be in the state's interest, could not also be used in connection with general obligation bond sales.

Similarly, the arbitrage profits that accrue from investing temporarily idle balances raised through the sale of certificates of participation are not evidence that this financing technique is less costly. There is no reason that bond sales could not be timed so as to achieve the same result--the maximum amount of net investment earnings permitted by the federal authorities--subject of course to avoiding excessively large sales of state bonds at any one point in time and being careful not to jeopardize the tax-exempt status of the bonds by selling them before plans and timetables for projects are pretty "firm."

C. ALLOCATION OF COSTS OVER TIME

The second criterion that we believe the Legislature should use in evaluating alternative capital outlay financing methods focuses on who benefits from a project and thus should pay for it. This is an important consideration with respect to capital outlay projects because such projects usually generate benefits and services to the population for many years after they are acquired or constructed. Thus, today's citizens derive significant benefits from parks, museums, roads, water systems and dams, and college buildings that were built or acquired in prior years.

From an economic standpoint, and perhaps from the standpoint of equity as well, it makes sense to finance capital outlay projects over the

same time period in which the benefits of the project are being realized by the taxpayers, with the costs spread roughly in relation to those benefits. Spreading the financing costs over time for public facilities with long service lives is somewhat analogous to levying user costs. Thus, a strong case can be made that future taxpayers should help "pay for" prisons that are built today because they too will eventually benefit from them.

This reasoning tends to favor debt financing or lease-purchase financing in comparison with direct appropriations. It is not so compelling, however, if today's taxpayers are not maintaining the existing stock of public capital generally, and thus are instead passing along to tomorrow's taxpayers a capital deficiency.

D. THE ISSUE OF TIMELINESS

The third criterion that we believe warrants consideration in choosing among capital outlay financing alternatives involves the time required to secure financing, and the costs that arise if financing is not available when it is needed. Delays in securing needed capital can arise at various points in the financing process. Specifically, delays can be encountered in getting approval for financing, in arranging for financing, and in actually obtaining the financial capital itself.

A financing alternative that cannot be pursued in a timely fashion may be unacceptable, even if it is attractive on other grounds. This is because delays in obtaining financing can interfere with the state's ability to provide needed public services, and can lead to higher project costs due to inflation. Timeliness, however, is not measured by the lead time necessary to secure needed financing. A financing alternative that is

characterized by a relatively lengthy timetable will not necessarily delay the provision of services or increase capital costs if the financing process is started early enough.

1. Time Lags Under the Direct Appropriation Route

When capital projects are financed through direct appropriations, financing-related time lags are minimal. This is because the Legislature can act quickly to appropriate funds.

This does not mean that an attempt to finance capital outlays through direct appropriation will not encounter delays. Such delays, however, generally tend to reflect legislative policy disagreements over whether and when a direct appropriation for a capital project should be made, rather than any delays inherent to the direct appropriation process per se. When the Legislature decides that a direct appropriation for capital outlay is needed and needed quickly, funds can be provided in a timely fashion.

2. Time Lags Under General Obligation Bond Financing

The issuance of general obligation bonds requires legislative action and the prior approval of the electorate. Thus, almost by definition, this financing mechanism takes more time than direct appropriations.

The normal chain of events in raising funds through general obligation bond sales begins with the Legislature authorizing a bond issue initiative. The initiative must then be voted on by the public at either a regular or special election. Next, assuming the initiative is approved by the voters, the finance committee which the bond initiative establishes must authorize the sale of bonds to underwriters, who subsequently resell the bonds to investors. Each of these steps normally takes time.

This process can be expedited if the need to obtain bond funds is extremely pressing. For example:

- Legislative authorization for a bond issue initiative could be obtained quickly in the same way that a direct appropriation can;
- The finance committee could authorize the sale of bonds as soon as it is formed--perhaps even the day after the voters' approval is secured; and
- The State Treasury can advance money to fund already-authorized bond-financed projects prior to the actual sale of the bonds, thereby eliminating the lags in marketing of bonds.

Even so, however, general obligation bond financing inevitably takes time. This is especially true if there is no existing voter-approved authorization for bonds to be sold for the purpose desired, thus creating the need to obtain voter approval. In such a circumstance, the length of time needed to arrange financing depends on when the next general election or direct primary election is scheduled (the California Constitution does not provide that a special election can be called to secure voter approval for the issuance of general obligation bonds).

3. Time Lags Under Tax-Exempt Lease-Purchase Financing

One of the commonest arguments made in favor of using a lease-purchase financing tool such as certificates of participation is that, because voter approval is not required, funds can be raised quickly. This is particularly true when the size of a capital project is small and the certificates of participation can be privately placed, as often occurs when lease-purchases of equipment (as opposed to capital facilities) are

involved. Even though certificate financing does not require voter approval, however, there are limits to the extent to which time lags can be avoided using this mechanism. This is especially true when the amount of funds to be raised is large, as is the case with state prison acquisition. This is because putting together large publicly offered certificate-of-participation leases is a complex undertaking, requiring many of the same legal and underwriting activities that bond issuance requires. In addition, unless some means is established for advancing funds to certificate-financed projects, these projects cannot commence prior to the actual sale of the certificates, which itself takes time. In contrast, funds can be advanced by the state for projects to be financed with general obligation bonds prior to the actual sale of bonds. We conclude that certificate financing probably can be undertaken more quickly than general obligation bond sales because voter approval is not necessary. Even so, it will normally take a number of months to complete, especially in connection with large projects. Evidence of this can be found in the experience of two counties which recently entered into lease-purchase agreements for jails--one in Colorado and one in Illinois. The officials we spoke to reported that it took 5 months to complete the certificate financing process in the Illinois case and 10 months in the Colorado case.

4. Policy Implications

Clearly, there are different time requirements associated with using different financing tools. How important these differences are is less clear. When a pressing need for capital outlay funds arises on very short notice, a case certainly can be made for using a financing alternative that

does not involve a long lead time. This type of circumstance, however, is more the exception than the rule. In the case of most capital outlay projects, there is at least some advance knowledge that the project is needed. In these circumstances, any type of financing can be used since, through proper planning, financing-related time lags can be explicitly incorporated into project timetables. For example, if general obligation bonds are to be used, voters can be asked to approve them early on, so that funds will be available when needed. (Certain voting-related delays in the use of general obligation bonds can also be avoided by ensuring that when bond authorizations are initially requested, the dollar volume is sufficient so that it will not be necessary to return to the voters prematurely.)

Finally, it should also be noted that while delays in financing can increase project costs due to inflation, they may also result in additional income. There are two reasons for this. First, available state monies that are not yet being used to pay the debt servicing costs on bonds or on certificates of participation could themselves be earning some return, since they could be temporarily invested in fairly high return taxable securities through the state's Pooled Money Investment Account. The second reason is that the state's income would itself rise with inflation. Thus, just because inflation raises a project's costs does not necessarily mean that the state is "less able" to fund the project. Given this, the primary concern which the Legislature should have regarding time delays in acquiring capital facilities using different means of financing involves whether needed public services are being withheld as a result of these delays.

CHAPTER III

CALIFORNIA DEPARTMENT OF CORRECTIONS' CONCLUSIONS AND RECOMMENDATIONS REGARDING FUNDING PRISON ACQUISITIONS

This chapter briefly summarizes the Department of Corrections' findings and recommendations regarding the use of lease or lease-purchase arrangements to finance prison construction. These findings and recommendations are set forth in a report submitted to the Legislature during January 1984, pursuant to Ch 958/83.

A. FINDINGS OF THE DEPARTMENT OF CORRECTIONS

The Department of Corrections' review of the potential for using lease or lease-purchase arrangements to finance prison construction included consultation with and assistance from a variety of state agencies and departments, as well as from financial underwriters in the private sector and representatives of investment banking firms. The department's recommendations regarding lease-purchase financing are based on the following findings and conclusions:

1. Raising most of the funding needed to complete new prison construction will require the use of general obligation bonds and/or lease-purchase financing, because there will not be sufficient General Fund or tidelands oil revenue available for direct appropriation.

2. Lease-purchase financing is a viable approach to financing prison expansion, given that it has already been used by the state to finance office buildings and by certain local governments to finance offices, police and jail facilities, and a variety of other types of capital facilities.

3. Were a lease-purchase financing approach used, the State Public Works Board or a nonprofit corporation could issue the financing instruments needed to raise the necessary capital. Various special marketing features applied to instruments like certificates of participation, such as "put options" and/or "variable" interest rates, could lower the financing cost of lease-purchase to the state and make it relatively competitive with general obligation bond financing.

4. Revenue bonds and certificates of participation require less time for approval and issuance when compared to general obligation bonds, and thus are desirable to fund prisons because they would result in more timely completion of the projects. In particular, the department concluded that:

- a. Reliance on general obligation bonds would delay prison construction 8 to 10 months. This conclusion assumed that a bond measure authorizing additional bond sales could not be placed on the ballot for voter approval before November 1984, and that it would take another 4 to 6 months before funds would be available for encumbrance. Based on this assumption, the department concluded that even though general obligation bonds might normally be less costly than lease-purchase financing, the "delay" associated with the use of general obligation bonds would result in (i) a \$17 million to \$22 million increase in prison construction costs due to inflation and (ii) a longer period during which the prison system would be overcrowded. (After the department

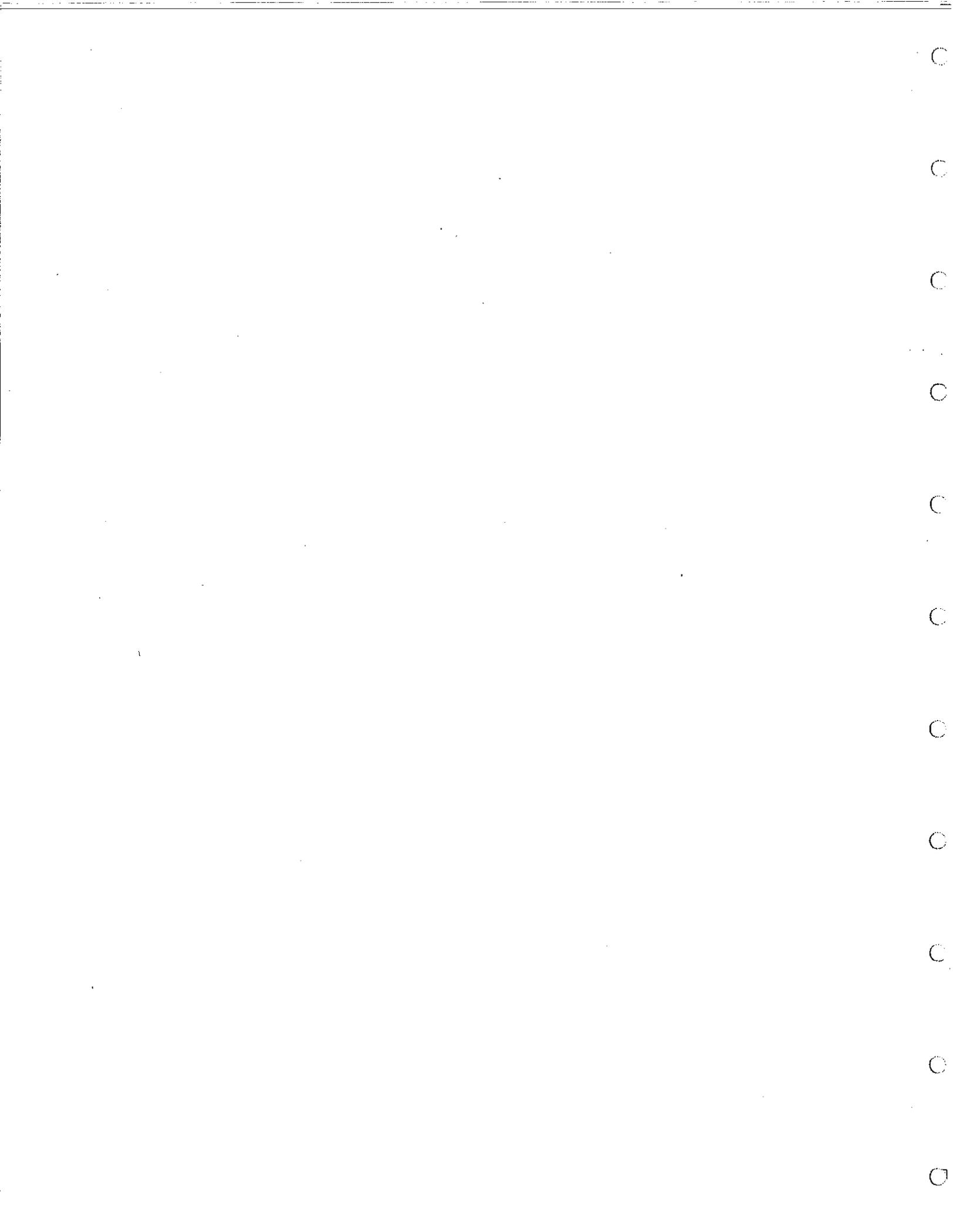
prepared its report, the Legislature enacted SB 310 (Ch 4/84), which placed a \$300 million state prison construction bond issue on the June 1984 ballot.)

- b. Lease-purchase funds could be made available almost immediately--by July 1984.

5. The use of lease-purchase financing should be restricted to the actual construction and acquisition of prison capital facilities themselves. In contrast, state funds should be appropriated directly for (a) the acquisition of land for new prison sites and (b) developing construction plans and related documents.

B. DEPARTMENT OF CORRECTIONS' RECOMMENDATIONS

Based on its findings and conclusions, the department recommended that legislation be enacted authorizing the State Public Works Board to finance prison construction and acquisition through lease-purchase arrangements, and that the board be given the flexibility to issue certificates of participation, revenue bonds, or any other financial market instruments that the board believes are appropriate and in the best interests of the state. The department indicates that provisions for necessary legislative review and control, plus departmental accountability, could be incorporated in the proposed legislation. The department, however, has not included any specific proposals regarding exactly what these provisions should be.



CHAPTER IV
LEGISLATIVE ANALYST'S CONCLUSIONS
REGARDING THE USE OF LEASE-PURCHASE FINANCING
FOR PRISON ACQUISITION

This chapter summarizes our conclusions regarding the desirability of using lease-purchase arrangements, such as those funded by certificates of participation, to finance the acquisition of state prison facilities. Specifically, the chapter discusses (1) our general findings regarding what is known about certificate-of-participation lease-purchase arrangements generally, (2) what is known about the use of lease-purchase financing specifically for state prison acquisition, (3) the extent to which financing availability is a constraint that is interfering with completion of the state's prison expansion program, and (4) the general desirability of using lease-purchase financing to expand the state's prison system.

A. CONCLUSIONS REGARDING THE USE OF TAX-EXEMPT LEASE-PURCHASE FINANCING
GENERALLY

Our analysis indicates the following:

1. State and local governments have increasingly turned to tax-exempt lease-purchase arrangements to finance capital acquisition in recent years. Although the exact volume of such arrangements is unknown, estimates by investment banking firms place it at well over \$1 billion per year nationally.

2. Tax-exempt lease-purchase financing combines direct governmental leasing with indirect governmental borrowing, so as to make a portion of the governmental entity's lease payments to investors exempt from taxation.

3. One of the most attractive forms of lease-purchase financing involves the use of certificates of participation. These certificates are sold, often by third parties, to investors who then hold fractional interests in the capital facilities financed with the proceeds. The facility is leased to the government pursuant to a contract that sets lease payments at a level sufficient to pay off the principal and interest on the securities. The lease-purchase agreement is considered a "conditional sale" for tax purposes, and while a portion of the lease payments is treated as tax-exempt income, the certificates of participation are not classified as "debt" to the issuer. Because of this, the certificates are not subject to debt restrictions such as interest rate ceilings, and do not require voter approval.

4. To date, most tax-exempt municipal leases have been used by state and local governments to acquire equipment, including telephone equipment, medical equipment, computers, and vehicles. Tax-exempt lease-purchase financing has also been increasingly and successfully used to acquire public buildings and other real property, such as schools, stadiums, and some jails.

5. In theory, tax-exempt municipal leases involving financial instruments such as certificates of participation could be used by the state to construct or acquire a wide variety of capital facilities, including state prison facilities authorized by the Legislature. In practice, however, the state would encounter certain problems which would reduce the attractiveness of lease-purchase financing. One of these

problems stems from the fact that the interests of investors are secured only by a lease that requires an appropriation of funds each year in order to be operative, and ultimately by the capital facility itself. Thus, the ease with which a facility leased to the state could be shifted to alternative uses will affect the government's costs under lease-purchase arrangements.

6. When tax-exempt lease-purchase arrangements are used to finance capital facilities, it makes sense for the state to directly appropriate General Fund or special funds monies to finance the costs of developing construction plans and related documents. By doing so, the state can maintain tight project control. The same logic, however, does not apply to the acquisition of sites for capital facilities. Contrary to what the Department of Corrections believes, we conclude that the state should obtain purchase options for sites and then assign them to the lessor. By doing so, the state will retain the maximum degree of decisionmaking flexibility in the future, should it determine to terminate a lease agreement.

7. In terms of costs, certificate-of-participation lease-purchase financing has certain advantages and disadvantages relative to general obligation bond financing. On the one hand, general obligation bonds are less risky for investors and therefore can be expected to carry a lower interest rate than certificates, although the interest rate differential can be eliminated by the purchase of certificate insurance. Such insurance, however, costs money. On the other hand, given current methods

of managing bond sales and maintaining reserve funds for lease-purchase arrangements, funds raised by certificates are more likely to generate arbitrage profits than are funds raised by bond sales. Both financing methods can be complex when used to raise large amounts through a public sale of securities, and each incurs legal and underwriting costs in such circumstances. When all of these factors are taken into account, we conclude that in most (but not necessarily all) circumstances, the cost of general obligation bond financing is likely to be somewhat less than the cost of certificate-of-participation lease-purchase financing.

8. Lease-purchase financing, like general obligation bond financing, enables the costs of acquiring capital facilities to be "spread out" over time, and thus does a better job of allocating the costs of a project among the project's beneficiaries than can be done using the direct appropriation route.

9. In terms of timeliness, direct appropriations minimize the time involved in obtaining funds for capital projects. Lease-purchase financing often will require less time to accomplish than general obligation bond financing. In most cases, however, this advantage can be overcome through advance planning. Consequently, the choice among these two financing methods generally can be based on cost differences.

B. CONCLUSIONS REGARDING THE USE OF LEASE-PURCHASE FINANCING FOR STATE PRISON ACQUISITION

To our knowledge, no state has attempted to construct a prison through a lease-purchase arrangement. Thus, there are no "case studies" available to examine the effectiveness of using lease-purchase arrangements

to acquire state prison facilities, especially when the financing requirements are as large as they are in California (potentially hundreds of millions of dollars).

On a smaller scale, we are aware of two instances in which lease-purchase financing has been used to construct jails. A county in Colorado has entered into a lease-purchase agreement that provides for construction of a 416-bed jail, with a Colorado bank acting as trustee. Certificates of participation totaling \$30.2 million and having a term of 9 years were sold at an average interest rate of 8.6 percent. The county will make 9 annual payments of \$5 million each, for a total cost of \$45 million. County officials indicated that it took 10 months to put this financing package together.

A county in Illinois entered into a lease-purchase arrangement with a legislatively established building commission. Although this arrangement is legally termed a lease-purchase arrangement, it is our understanding that the bonds which were sold by the commission have the backing of the county and are thus considered by investors to be equivalent to general obligation bonds. The commission official we spoke with indicated that it took approximately five months to arrange this financing package.

Thus, in both cases it took time to put the certificate-of-participation financing package together.

C. IS THE AVAILABILITY OF FINANCING THE CONSTRAINT TO EXPANDING PRISON CAPACITY?

It is generally agreed that there is a very substantial and pressing need for the state to expand its prison capacity. As noted in the previous

chapter, the Department of Corrections recommends that the state utilize lease-purchase financing in order to speed up the prison construction program. Since there is no hard evidence that lease-purchase financing is less costly to the state than regular general obligation bond financing, and there is some evidence that the reverse is true, it would seem that the Legislature would want to document the claim that the availability of financing is the constraint holding back the construction program before proceeding with lease-purchase financing.

Our general finding is that financing per se currently is not the major constraint to the prison expansion program. Rather, the constraints seem to be (1) the problems encountered by the state in attempting to locate acceptable sites for new prisons and (2) the ability of the Department of Corrections to meet its own capital outlay project timetables. As a result, we do not believe that adoption of lease-purchase financing using certificates of participation, by itself, will do much to accelerate the program. The basis for this conclusion is discussed below.

1. Problems of Acquiring Prison Sites and Meeting Capital Outlay Project Timetables

To date, the Legislature has appropriated over \$434 million for new prison construction. The department, however, indicates that as of December 31, 1983, only \$74.1 million had been encumbered and most of this encumbrance (\$58.5 million) is related to one prison complex at Tehachapi. Consequently, delays in constructing new prisons would seem to reflect the department's inability to get projects "on-line," rather than insufficient funds available for new construction.

In its January 1984 report, the department assumes that the majority of the new prison construction program will require construction financing--beyond what has already been authorized--between July 1, 1984, and January 1, 1985. Given the current status of the department's construction program, we believe that this assumption is highly improbable. The status of the major projects that comprise this program is as follows:

- Adelanto Maximum Security Prison. Funds needed to complete--\$89.7 million. The department's schedule calls for design to start in January 1984 and the construction phase of the housing units to begin in September 1984. At the time this report was written, the department's environmental impact report was the subject of litigation, a contract for architectural services had not been signed, and design had not been started.
- San Diego Minimum Security Prison. Funds needed to complete--\$107.1 million. The department's schedule indicates that design will begin in April 1984, and the construction phase of the housing units will start October 1984. At the time this report was written, the department was reevaluating the correctional program for this site and a contract for architectural services to rewrite the architectural/correctional program had recently been signed, but a contract for designing the facilities had not been signed.
- Riverside County Medium Security Prison. Funds needed to complete--\$88.2 million. The department's schedule requires (a)

the environmental impact report to be in progress during December 1983 and completed by June 1984, (b) design of the facilities to start in May 1984, and (c) the construction phase to begin in December 1984 for site development and in February 1985 for the housing units. At the time this report was written, the department was planning to start an environmental impact report on four potential sites, but it had neither selected a site, nor signed a contract for architectural services.

- Los Angeles Medium Security Prison. Funds needed to complete--\$88.2 million. The department's schedule requires that the environmental impact report be started in March 1984 and be completed in August 1984. Design work is scheduled to begin in April 1984 (prior to completion of the environmental impact report), and the construction phase is supposed to begin in April 1985 for site work and in August 1985 for the housing units. At the time this report was written, the department had neither submitted the proposed site for the facility to the Legislature for review, nor had a contract for architectural services been signed.
- Vacaville Minimum Security Prison. Funds needed to complete--\$45 million. The department's schedule calls for the construction of the housing units for this prison to begin in April 1984. According to the Governor's Budget, funds needed to complete this project will be requested under special legislation in the

current year. Therefore, these funds will not be part of any proposed bond or lease-purchase program.

- Avenal Minimum Security Prison. Funds needed to complete--\$116.3 million. The department's schedule calls for the environmental impact report to be in progress in December 1983 and to be completed in April 1984. The design of the prison was to begin in January 1984 (prior to completion of the environmental impact report or selection of a site), with the construction phase beginning in August 1984 for the site work and in October 1984 for the housing units. At the time this report was written, an environmental impact report was underway but a site had not been selected (although three sites are under consideration), and a contract for architectural services had not been signed.
- Northern California Womens Facility. Funds needed to complete--\$24.9 million. The department's schedule calls for the environmental impact report to be completed in February 1984, with design to start in February 1984 and the construction phase to begin December 1984. This facility is planned to be constructed on state-owned property in the Stockton area. Consequently, assuming the environmental impact report is cleared, gaining control of this site should not pose a problem. At the time this report was written, the environmental impact report was in progress but had not been completed, and a contract for architectural services had not been signed.

We have discussed with the department some of the problems and inconsistencies in its project schedules, such as (a) starting design of facilities prior to selecting a site and/or prior to completing an environmental impact report, and (b) starting design prior to signing a contract with the architect. The department has been unable to justify these practices. In addition, department staff has indicated that the schedules should be considered "milestones," rather than as "firm" schedules, and further indicates that the schedules are based on "desired" occupancy dates and do not necessarily show the various aspects of "needed" work to construct the prisons. If this is so, then one wonders of what possible practical value such timetables are.

For many of the proposed prison sites, there are problems with (a) site acquisition, (b) obtaining site utility services, such as sewer, electricity, water, and/or (c) the time frames for the design and/or construction phases. None of these problems are adequately accounted for in the department's time schedules. In fact, in no instance has the department been able to verify the design and construction time schedules for an individual prison. Each of these problems must be addressed before a realistic project schedule can be established and used as the basis for figuring out exactly when funds will be needed so that the projects can proceed without unnecessary delays.

2. Summary

In view of these problems and the general lack of reliability of and analytical basis for the department's own project schedules, the

department's assertion that lease-purchase financing is needed because reliance on general obligation bonds or direct appropriations (for which funds are limited) will cause an unnecessary delay in prison construction appears to be totally unfounded.

D. THE DESIRABILITY OF ADOPTING LEASE-PURCHASE FINANCING FOR STATE PRISON ACQUISITION IN CALIFORNIA

Based upon the information presented in the preceding pages, we find no convincing reason for relying on lease-purchase financing, using securities such as certificates of participation, to acquire state prisons.

This is not to say that lease-purchase financing could not be attempted for prison-related capital outlay purposes. Indeed, it could, and, in many circumstances, probably would work quite well. Our point simply is that the advantages of using lease-purchase financing are not evident, and adopting this financing mechanism would not necessarily accelerate the state's prison construction program. Specifically:

- There is no clear evidence that--given the large sums of money that must be raised and the particular type of project involved--lease-purchase financing would be as attractive as general obligation bond financing from a cost standpoint. The underwriting costs of a large general obligation bond sale could be "spread over" a very large financing base, and no insurance would be required to minimize the interest rate that the state would have to pay. In addition, the security that would stand behind the certificates of participation--state lease payments subject to annual appropriation and backed by the prison facility

itself--is not nearly as reassuring as either (1) the state's full faith and credit or (2) the more-marketable facilities which frequently secure lease arrangements, such as office buildings.

- Given the delays in finding acceptable prison sites and designing facilities, whatever advantages lease-purchase arrangements might offer in terms of raising capital expeditiously are of less importance. This clearly is the case in 1984, when large amounts of already-authorized general obligation bond funds are available but cannot be spent because of delays in prison site acquisition and design. Hence, the financing of new prison construction, to date, has not been a significant constraint on expanding the prison system.

In summary, we do not believe that lease-purchase financing of state prisons should necessarily be ruled out in the future. On the other hand, we see no reason why the state, at this point, should turn to a financing mechanism which has not been shown to be the least costly and most effective financing tool available to the state. This is especially so, given that a pretty strong case can be made for general obligation bonds as a more cost-effective approach, assuming that the Legislature decides to fund prison acquisition by borrowing instead of through direct appropriation.

CHAPTER V
RECOMMENDATIONS TO THE LEGISLATURE

Based upon the findings from our analysis of alternative mechanisms for financing the construction of state prisons, we recommend that, at least for the present, the Legislature consider using lease-purchase financing only after it has made the policy decision not to use the state's General Fund monies, tidelands oil revenues, and/or general obligation bonds to finance completion of the prison construction program. This is not meant to imply that lease-purchase financing should not be considered as a financing method. Under the right circumstances, it might indeed prove to be the best financing option available to the Legislature. Nevertheless, recognizing California's--and, in fact, everyone's--lack of experience with this mechanism for financing large-scale prison capital outlay projects, a commitment to using this financing tool as a first resort, rather than a last resort, would be premature. Before the state takes on the uncertainties associated with lease-purchase financing, the Legislature should require stronger evidence that this approach will be the least costly and most efficient alternative available. In our view, this has yet to be demonstrated.

In the event that the Legislature does decide to use a lease-purchase approach to financing the construction or acquisition of state prison facilities, we recommend that:

1. Construction plans and related documents for new prisons be funded by direct appropriations from the General Fund or special funds.

This will ensure that the state maintains the needed degree of control over the design of prison projects.

2. Land acquisition for new prisons be made the responsibility of the lessor, and not be financed by direct appropriations as recommended by the Department of Corrections. The state, however, should obtain a site purchase option and assign it, as part of the lease agreement, to the lessor. This will serve to maximize the state's decisionmaking flexibility in the future, which is one of the economic advantages which the lease-purchase option is supposed to offer.