Cost Effective Borrowing, Enhanced Transparency, and Management Best Practices
The Better Way to Build Schools Initiative

Use of Short Term Current Interest Bonds.

The traditional way that school debt is financed involves very long term debt at moderately high interest rates. The result is that the cost of the debt in terms of the final amount collected from taxpayers is considerably higher than the amount of cash received. As an example, District A is set to issue $40 Million in bonds.

1. Option 1. Bonds are issued as standard long term debt, 30 years at 5.25% interest. In this case In addition to paying back the $40 M in borrowed capital, the District also pays back around $40M in interest
2. Option 2. Due to the high existing debt load of the District, the new Bonds are issued as Capital Appreciation Bonds over 30 years. Neither principal nor interest payments the first few years. In this case, in addition to paying back the $40M in borrowed capital, the District also pays back around $120M in interest
3. Option 3. The new Bonds are issued as short term Current Interest Bonds over 3 years. After 3 years the Bonds are completely paid off. In this case, while the tax rates are at the maximum $60/$100,000 in Assessed Valuation allowable by law, the District pays only approximately $500,000 in interest.

Option 3 in this case study actually describes the basic financial structure of the first "Pay-as-you-Go" (or Pay-Go) Bond Issued by San Juan Unified School District as part of the issuances under Measure N. By issuing short term debt, the interest rate dropped dramatically, in the case of San Juan to under 0.5% The underwriter's spread was also dramatically reduced, increasing the amount of money raised that actually went to the District. The short term of the Bond meant that the principal was taken down extremely quickly, dramatically reducing the figure that the interest rate was multiplied against After the Bond funds are spent, another short term bond can be sold, replenishing the building fund. Since the Bonds are paid off shortly after they are issued, there is no accumulation of new debt over time.

This strategy works particularly well for medium to large Districts with a large number of projects to accomplish over an extended period of time. In effect, the construction program becomes "evergreened", with construction occurring at a somewhat slower but much more sustainable pace. This helps with both cost and quality in that it converts from the Boom/Bust concept common to many School Construction programs to one of sustained delivery. Yet again, the impact of Pre-Checked plans help make this technique more attractive, as the first cost reduction inherent in the approach lets a reduced number of dollars go farther.

Since the maximum amount that a District can tax in a year is limited for any single bond, the amount of money that can be obtained up front via this strategy is lower than traditional "all funds up front" Bonding plans. In the cases of a District that has a low Assessed Value and a single school, the ability to

do a large project all at once is not possible, but there are other ways to accommodate the need. One way would be to perform the project in phases. Secondly, an additional Bond could be sold to add to the cash available at the beginning of the process.

The opposite of this approach is the use of CABs. In the example that brought attention to the problem, a District in Poway sold bonds where taxpayers will pay over $980M in debt service to pay back the $105M in principal that the District received, a ratio of over 9.3-to-1. Other Districts have sold CABs with even higher debt ratios. In 2009 Folsom-Cordova USD sold a CAB the gained them just over $500,000, but with a 17.7-to-1 ratio taxpayers will charged a cool $9.1M[1]. Rim of the World school District outdid Folsom Cordova, selling a CAB with an astounding 23.4-to-1 ratio. By comparison, the San Juan Pay-Go bond mentioned above had a repayment ratio of just 1.01-to-1, a repayment ratio just 4% of that of the Rim of the World CAB.

Local Economic Impacts. In addition to looking at the total cost to taxpayers, another way to look at this is in terms of the economic impacts. In the case of the Folsom-Cordova CAB, roughly 95 cents of every dollar collected from taxpayers went to institutional bond investors via Wall Street as interest, leaving the community. Under the San Juan Pay-Go plan just over 1 cent went to interest, with the remainder being spent on actual construction costs. Over the life of a $120M bond for example, this effect can be significant when compared to a Traditional long term Bond. For example, a series of three $40M "Pay-Go" bonds would pay between $1-$2M in interest, while a 5.25%/30 year bond would cost $120M in interest. In effect, it is the opposite of stimulus, resulting in large cash flows out of a community every year for decades that would not otherwise need to occur.

The positive effects of using San Juan style bonds can be amplified by the implementation of first cost reduction strategies. In constructing a school the number of labor hours is relatively constant whether the plans are Pre-Checked or custom, whether the materials and equipment are purchased using co-operative purchasing or not, and whether the professional services are competitively bid or not[2]. If the first costs are reduced by 40% via those first cost reduction mechanisms, then the share of tax dollars collected going to worker wage packets increases by 2/3^{rds}. If the cost of borrowing money is cut by 50% by way of going from long term bonds to San Juan style "Pay-Go" bonds and combined with a 40% first cost reduction, then fully three times as many of the tax dollars being raised are going to construction worker paychecks.

Cumulatively these impacts on local economic conditions are significant. Lower total cost means that almost all of the dollars being raised through taxes are now being spent on the projects instead of interest, so everyone in the community has a bit more money in their pocket every month, boosting disposable income. Additionally, far more of the dollars raised are going to local workers. Much of this money will still leave the community as payments to equipment vendors, suppliers and the like, but the money that does remain will recirculated, and payments to workers are likely to circulate more. While it

[1] http://spreadsheets.latimes.com/capital-appreciation-bonds/

[2] If the same plans are used repeatedly there should be some level of efficiency gain, resulting in a relatively small drop in the number of labor hours per school.

may be bad for Wall Street, a plan like this is much better for Main Street, both the businesses located there and the workers who shop in the stores

Incidentally, the incorporation of First Cost Reduction Strategies makes this system even more cost effective: as fewer dollars are needed to complete a given site, use of short term bonding makes more sense.

Enhanced Oversight.

While the Bond Oversight Committees Prop 39 introduced were not unheard of prior to its passage, Prop 39 made them mandatory. From the experience of the last 14 years the factor that is most apparent is that for oversight to be effective, it must be truly independent. This independence comes in two ways: independence on the BOC, and independence of the auditors.

Independence of Nomination. Too often, BOC members are selected from amongst the friends and acquaintances of the members of the School Board. Selection of BOC members from this limited pool results a BOC that tend to owe its allegiance to the School Board instead of the public at large, and is often associated with a significant reduction in the rigor of the oversight process.

A different method that is used in a minority of Districts however produces a significantly elevated level of oversight. The members of some BOCs are nominated by independent civic groups, including Chambers of Commerce, Building/Construction Trades Councils, Seniors groups, Taxpayer organizations, and even interfaith religious coalitions. The difference is critical; when BOC members are nominated by these outside groups, their allegiance is to their organization and the public, not to the School itself. While less rigorous oversight may be attractive to a District in the short term, in the long term Districts are far better served by BOCs that have the ability to uncover problems at their inception, and the ability to bring cost control and oversight expertise to the program as early as possible are truly helpful to the District in the long run.

Independence in auditing. As mentioned above, it is a recognized best practice to have the financial and performance audits of the Bond performed by a different firm than that that performs the audit of the District as a whole, even if this compels a slightly higher price. The reason for this is the appearance of impropriety, and the corrosive effect that this can have on public confidence.

The engagement to perform the Bond Audits may be in the tens of thousands of dollars, while the engagement to perform auditing of the District's own books may be in the hundreds of thousands of dollars or more. It is not uncommon at all for the audit of a school district to be the single largest engagement for a given CPA, one that has an outsized effect on the financial fortunes of their team and firm. As such, it is difficult to avoid a conflict of interest when reporting on any potential improprieties found in the completion of the Bond audit places the much more lucrative District engagement in jeopardy. Further, in cases where problems have been found to occur in Bond spending and the same firm is used for all of the audits, the prevalence of "swallowing the whistle" and failing to include concerns in their conclusions is nearly universal.

Management Best Practices

Life Cycle Cost Analysis. The nature of the split between bond fund expenditures and operating funds gives rise to a well understood tension. Bond funds are only to be used for capital improvements, while operating funds are only to be used for operations. The problem is that the amount of Bond funds spent can impact future operating funds. Due to political and other pressures, in many cases Operating funds are given a higher priority than Bond funds. At the extreme end, this can result in perverse outcomes.

For example, imagine a Direct Digital Control system for an elementary school. Compared to a more basic alternative, this system has an incremental cost of $350,000. The system can save an average of $10,000 per year over its life, with an expected useful life of 15 years. Does this marginal expenditure make sense?

To an ordinary business, the answer would clearly be no. Even without taking into account the bond interest that would accrue on the $350k, the DDC system would only give $150K in return. More importantly, the total cost of the system to taxpayers of a system could be over $800,000 including interest while the net present value of the stream of savings could be under $95,000. However, to a District with severe operating budget pressures, the thought of a revenue stream that rises from $8,100 per annum to over $12,000 per annum could be very appealing when considering that the first cost to the *operating* budget is zero.

What this fails to recognize though is that actions like this, when discovered, have a profoundly negative and corrosive effect on the faith that voters have in the fiscal rectitude of the District. When instances like this are brought to the attention of the media, particularly during future campaigns, the impacts can easily sway the vote against future Bond measures for years to come. Ultimately, not only is this wasteful of limited capital project funds, any short term benefit to the operating budget is more than offset by long-term harm to future generations of students.

The way to deal with this is straightforward: incremental life cycle cost analysis for discretionary projects or the discretionary portions of mandatory contracts. From the standpoint of the Taxpayer's Association, this does not need to show a significantly positive return on investment, nor does it need to discount future avoided cost cash flows. Instead, a simple analysis that shows that incremental expenditures, including the time cost of those dollars will be less than the total avoided operational costs over the federally recognized Expected Useful Life of the equipment is sufficient. This study should be completed by a competent professional; all calculations and assumptions should be shown, and the results attested to by a licensed Engineer or Architect in a signed and stamped document. This analysis, in this format, ensures that they are placing their Errors and Omissions insurance behind the calculations on this form.

Local Districts are showing the way on this issue. Folsom Cordova Unified School District recently adopted a District Policy that states the following[3]:

> "… that when renovations include upgrades or non-essential modifications, the District shall perform a cost-benefit analysis that shows that the true marginal cost of the upgrade or improvement over its life, including marginal costs *and marginal interest cost*[4], will be at least equal to its savings over its expected life.

The example used is for a football field, where the cost of a grass turf field is $100,000, and the cost for an artificial turf field is $600,000. Under this policy, the incremental $500,000 and the associated marginal interest costs would need to be offset by savings in water and maintenance costs over the expected useful life of the field. Further, the analysis that shows that this incremental expenditure is at least break even must be attested to and available for public review.

Prohibiting use of "No-bid" contracting methods to Campaign contributors. There are things that can be done that, while legal, are still corrosive to public trust. One of those things is the granting of contracts for professional services on a no-bid basis to past campaign contributors. While this recommendation may seem to be in the realm of being so common sense that it does not need to be mentioned, it occurs often enough to require its inclusion in this Best Practices section.

Use of Competitive Selection for Financial Analysts. The Government Financial Officers Association (GFOA) has extremely well written guidelines for many processes in the bond process, including the selection of Financial Advisors. These recommendations are covered very well in a Section of the "Debt Toolkit" document produced by Dr. Mary Barlow, Assistant Superintendent of Schools for Kern County[5]. The Financial Advisor selection process is covered starting on PDF page 40. One section is quite important:

> Fees paid to financial advisors should be on an hourly or retainer basis, reflecting the nature of the services to the issuer. Generally, financial advisory fees should not be paid on a contingent basis to remove the potential incentive for the financial advisor to provide advice that might unnecessarily lead to the issuance of bonds.

The goal in this section is to remove any potential conflict whereby the financial interests of the advisor and the District may become misaligned.

Incorporation in Ballot Language. The intentions of many Board memebrs when going out for a bond may be good, but if those intentions are not included in the Ballot Language or in a document referenced in the Ballot Language, the intentions at the time of the election may not be realized in the way that the Bond funds are spent. By incorporating the intent in the Ballot Language, all parties know in advance that the commitment smade during the campaign will be adhered to during the time when

---

[3] http://folsom.csbaagendaonline.net/cgi-bin/WebObjects/folsom-eAgenda.woa/wo/15.0.7.1.3.0.0.7.3.1.27.9.0.4.1.1.1.0.3.1.0.0.1.0

[4] The italicized section on marginal interest cost were added at the meeting following a suggestion from the Sacramento Taxpayers Association. This is reflected on page 10 of the minutes of that meeting. http://folsom.csbaagendaonline.net/cgi-bin/WebObjects/folsom-eAgenda.woa/wo/25.0.7.1.3.0.0.7.3.1.27.9.0.4.1.1.1.0.3.1.0.0.1.0

[5] http://kern.org/finance/wp-content/uploads/sites/26/2014/03/Debt-Toolkit-Final1.pdf

bonds are being spent, even if there are subsequent changes on the School Board or District leadership. This commitment to follow through as stated is immensely helpful in securing and maintaining public confidence, as nothing will undermine that confidence in the process more than a perception of “Bait and Switch”. Having these procedures incorporated in the Ballot Language, either directly or by reference, also reduces the opportunities for misunderstandings later.

Ultimately, what the measures recommended by the Better Way Initiative are about is cost effective school design, not the denial of projects. Our best practices are about subjecting the proposed delivery method to rigorous analysis and the power of competition in the marketplace, and ensuring that our community as a whole gets the most for the dollars that will leave as taxes. We are all taxpayers, either directly as property owners or indirectly as renters, and the decisions that we make today will affect taxes for decades to come. Ultimately, adopting more cost effective ways of delivering school projects not only helps the taxpayers of today, it also helps those who will pay those taxes in the future. If the kids who are in the classrooms today deserve a great learning environment, they deserve at least as much to be free from unnecessarily high debt burdens when they enter our community as adults in the future.