# Texas Public Finance Authority

## Staff Report

# Texas Sunset Advisory Commission

1996

TEXAS SUNSET ADVISORY COMMISSION



In 1977, the Texas Legislature created the Sunset Advisory Commission to identify and eliminate waste, duplication, and inefficiency in government agencies. The 10-member Commission is a legislative body that reviews the policies and programs of more than 150 government agencies every 12 years. The Commission questions the need for each agency, looks for potential duplication of other public services or programs, and considers new and innovative changes to improve each agency's operations and activities. The Commission seeks public input through hearings on every agency under Sunset review and recommends actions on each agency to the full Legislature. In most cases, agencies under Sunset review are automatically abolished unless legislation is enacted to continue them.

# TEXAS PUBLIC FINANCE AUTHORITY

## SUNSET STAFF REPORT

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# EXECUTIVE SUMMARY

# Executive Summary

The Texas Public Finance Authority (TPFA) is responsible for providing cost-effective bond financing to its client agencies for legislative-approved projects and to ensure timely and accurate payment of debt service on those bonds. TPFA currently issues bonds on behalf of 13 state agencies. In addition, TPFA administers the state's Master Lease Purchase Program and can provide financing to convert fleet vehicles to alternative fuels for state agencies and political subdivisions. The Sunset review focused on ways to save state resources by requiring more state agencies and institutions of higher education to pool their bond issuances within TPFA. The review also focused on ways to improve the bond issuance process within TPFA. The following material describes the results of our review efforts.

### 1. Consolidate Bonding Authority of Agencies with Small and Infrequent State Bond Issuances into TPFA.

Several universities and one state agency issue bonds so infrequently and in such small amounts that costs associated with issuing their bonds are substantially higher than those issued by TPFA. The high per-bond cost of small bond sales wastes state resources by incurring bonded debt that is higher than necessary.

***Recommendation***: Require the following universities and one state agency to issue bonds through TPFA:

- The University of North Texas,
- Midwestern State University,
- Stephen F. Austin State University,
- Texas Southern University,
- Texas Woman's University, and
- Texas Lower Level Radioactive Waste Disposal Authority

### 2. Improve TPFA's Interaction with Client Agencies by Requiring an Early, Plain Language Orientation to the Agency's Bond Issuance Process.

TPFA's client agencies do not have the bond-related expertise of TPFA staff. Because of this lack of expertise, these agencies are not as familiar or adept in the bond issuance process. By establishing an orientation process, client agencies will have a better understanding of the process and be able to better plan for its demands on staff and resources. TPFA can also use the orientation process to obtain needed information from its client agencies.

***Recommendation***: Require TPFA to develop an orientation to the bond issuance process for client agencies that includes:

- plain language information explaining the bonding process, and
- an orientation meeting held before the bond issuance process begins.

### 3. Continue TPFA for 12 Years.

A continuing need exists to provide cost-effective bond financing for TPFA's client agencies' legislatively approved projects, and to ensure timely and accurate payment of debt service on those bonds.  TPFA effectively meets these needs.

***Recommendation***: Continue TPFA for 12 years.

## Fiscal Impact Summary

These recommendations will result in savings to the state from consolidating the bond issuance authority of five universities and one state agency within TPFA.  However, the amount of savings cannot be estimated at this time since the number of legislatively authorized bond issues needed in the future is not known.   The recommendation to continue TPFA would require TPFA's annual appropriation of about $600,000 to continue.  However, since the money used to fund TPFA comes from revenue bond proceeds, this appropriation would have no effect on the General Revenue Fund.

# Approach and Results

# Approach and Results

## Approach

The mission of the Texas Public Finance Authority (TPFA) is to provide cost-effective bond financing for legislatively approved projects and to ensure timely and accurate payment of debt service on those bonds. This mission began in 1983 when the Legislature authorized TPFA (then the Texas Public Building Authority) to issue revenue bonds on behalf of the General Services Commission. Since 1983, the Legislature has authorized TPFA to issue general obligation bonds and commercial paper and has required 11 other state agencies and the Texas State Technical College System to issue their bonds through TPFA.

*TPFA's mission is to provide bond financing for legislatively approved projects and to pay debt service on those bonds.*

Texas has a history of limiting use of long-term debt to finance government infrastructure. The state Constitution prohibits state government's use of general obligation bonds unless the voters pass a constitutional amendment authorizing debt financing for a specific project. The Sunset review did not evaluate the state's policy concerning the use of debt financing. Instead, the review examined the efficiency of the state's approach of issuing debt and administering the repayment of that debt. This approach included an evaluation of the benefits of requiring other state agencies or institutions of higher education to issue bonds through TPFA.

This report uses two tools to help explain bonds and the underwriting process. Throughout the report, italics are used to differentiate general obligation bonds from revenue bonds. In addition, the report uses text boxes that contain the definitions of key terms. A term in bold typeface within the text is defined within a nearby key term text box.

## Review Activities

In conducting the TPFA review, the Sunset staff performed several activities:

- Worked closely with the TPFA staff;

- Reviewed state statutes, the state Constitution, past legislation, agency documents and information available on the Internet;
- Attended public meetings of the TPFA Board and Bond Review Board;
- Met with TPFA's client agencies to discuss their experiences relating to TPFA;
- Researched agencies in other states with similar functions;
- Met with staff and faculty from the Bond Review Board and the University of Texas, Lyndon B. Johnson School of Public Affairs;
- Worked with personnel of potential TPFA client agencies to obtain data on bond issuance practices at those agencies; and
- Attended the Texas Public Finance Conference sponsored by the Bond Buyer.

*TPFA has been a cost-effective issuer of state bonds.*

The Sunset staff wishes to acknowledge the assistance of Austin Tobin, President, of Delphis Hanover Corporation for examining and validating the methodology used in comparing the bond issuance costs of other state agencies or institutions of higher education being considered for consolidation with TPFA.

## Results

The Sunset review of TPFA started with answering the question of whether the functions performed by TPFA continue to be needed. The mission of the Texas Public Finance Authority (TPFA) is to provide cost-effective bond financing for legislatively-approved projects and to ensure timely and accurate payment of debt service on those bonds. The Sunset staff concluded that the functions currently performed by TPFA to achieve this mission should continue.

Once TPFA's functions were determined necessary, the focus of the review shifted to the organizational structure used to carry out these functions. TPFA was evaluated to see if the agency effectively carries out its functions and whether transfer of some or all of its functions was warranted. The review showed that TPFA has been a cost-effective state bond issuer. In addition, no substantial benefits would result from transferring TPFA functions to another agency. Although the staff took a close look at consolidation with the Bond Review Board (BRB), combining TPFA with BRB would result in an oversight agency approving its own bond deals. Sunset staff addressed continuing TPFA and its organizational structure in **Issue 3**.

The primary focus of the review was to determine if the state could save resources by having other state agencies and institutions of higher education use TPFA to issue bonds on their behalf. In identifying potential TPFA client agencies, Sunset staff sought to determine which agencies and universities issue bonds infrequently and in small amounts. Such bond issuances are very costly and can be easily pooled with other large bond issuances to minimize costs associated with selling bonds. The review identified several instances where high per-bond costs for small bond sales could be avoided. **Issue 1** analyzes the costs associated with issuing bonds of five other universities and one other state agency and discusses the benefits of having TPFA issue bonds on their behalf.

*Small and infrequent bond issuances are costly and can be pooled with larger issues to minimize costs.*

The review also examined ways to enhance the efficiency of the bond issuance process. In its discussions with TPFA client agencies, Sunset staff found TPFA was generally viewed very favorably; however, discussions also showed that the current process of issuing bonds suffers from inadequate initial communications. **Issue 2** addresses this situation and provides guidance to TPFA and its client agencies on the information needed to enhance the bond issuance process.

## Recommendations

1. Consolidate bonding authority of agencies with small and infrequent state bond issuances into TPFA.

2. Improve TPFA's interaction with client agencies by requiring an early, plain language orientation to TPFA's bond issuance process.

3. Continue the TPFA for 12 years.

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# ISSUES

# Issue 1

## Consolidate Bonding Authority of Agencies with Small and Infrequent State Bond Issuances into TPFA.

### Background

Generally, the state issues tax-exempt municipal bonds for two purposes: to finance loan programs that generate sufficient revenues to repay the bonds without drawing on the state's general revenue; and to raise funds for construction of buildings, prisons, and other capital projects. The state uses two approaches to issue bonds for these purposes. The first approach authorizes individual entities to issue bonds. The second approach, known as "consolidation", authorizes one agency to issue bonds on behalf of a number of other entities. This method is used in an attempt to minimize bond issuance expenses.

The state currently has 19 entities authorized to issue bonds - nine state agencies and ten institutions of higher education. The chart, *Current Texas State Bond Issuers*, shows the state entities that currently have the authority to issue state bonds. Only one of these entities, the Texas Public Finance Authority (TPFA), issues bonds on behalf of other agencies.

In considering consolidation as a method of bond issuance, one must examine two factors. These two factors, **issuance costs** and **spread** affect how much a state entity pays to bring a bond issue to market. Issuance costs are subject to economies of scale since dollars paid to issue bonds do not increase proportionately with the size of the bond sale. As a result, the larger the bond issue, the lower the issuance costs per bond.

Spread is made up of four separate components: the management fee, takedown, the underwriting fee, and expenses. The management fee compensates the **underwriter** for efforts in developing and implementing the bond sale to investors. Takedown is the discount at which the underwriter buys or "takes down" bonds from the issuer. For example, if the takedown is $10 for each $1,000 of bonds issued, the underwriter will pay the bond issuer $990 for each $1,000 of

**Key Terms**

**Issuance Costs** - fees and expenses paid to bond consultants for legal and financial advisory services, as well as fees for document drafting and printing, travel, and other bond-related expenses.

**Spread** - the profit made by an underwriter involved in selling a particular bond issue.

**Underwriter** - intermediaries between bond issuers and investors. Underwriters purchase whole bond issues from issuers and resell pieces of that bond issue to investors at a profit.

| Current Texas State Bond Issuers | Total Number of Issues FY's 1988-1994 | Total Amount Issued FY's 1988-1994 | Average Amount Per Issue |
|---|---|---|---|
| **Smaller Issuers** | | | |
| Texas Agricultural Finance Authority | 1 | $25,000,000 | $25,000,000 |
| Texas Department of Commerce | 1 | $25,000,000 | $25,000,000 |
| Higher Education Coordinating Board | 8 | $479,488,044 | $59,936,006 |
| University of Houston System | 3 | $123,400,000 | $41,133,333 |
| Texas Lower Level Radioactive Waste Disposal Authority (TLLRWDA) | 0 | $0 | $0 |
| Midwestern State University (MSU) | 3 | $2,600,000 | $866,667 |
| University of North Texas (UNT) | 2 | $16,320,000 | $8,160,000 |
| Texas State University System | 4 | $59,245,000 | $14,811,250 |
| Stephen F. Austin State University (SFASU) | 4 | $26,820,000 | $6,705,000 |
| Texas Southern University (TSU) | 1 | $20,845,000 | $20,845,000 |
| Texas Tech University | 2 | $60,510,000 | $30,255,000 |
| Texas Turnpike Authority | 3 | $510,000,000 | $170,300,000 |
| Texas Woman's University (TWU) | 2 | $9,810,000 | $4,905,000 |
| **Total Small Issuers** | **34** | **$1,359,038,044** | **$39,971,707** |
| **Larger Issuers** | | | |
| Texas A&M System | 14 | $345,143,668 | $24,653,119 |
| Texas Dept. of Housing & Community Affairs | 30 | $1,109,055,932 | $36,968,531 |
| Texas Public Finance Authority (TPFA) | 39 | $4,655,032,603 | $119,359,810 |
| University of Texas System | 10 | $364,785,000 | $36,478,500 |
| Texas Veterans' Land Board | 15 | $599,384,533 | $39,958,969 |
| Texas Water Development Board/TWRFA | 13 | $1,245,945,000 | $95,841,923 |
| **Total Large Issuers** | **121** | **$8,319,346,736** | **$68,754,932** |

Shaded entities were the subject of Sunset staff analysis for possible consolidation.
Source: TPFA, from Bond Review Board data supplemented by Water Development Board.

*Sunset staff explored opportunities to reduce the amount of state funds used to sell bonds.*

bonds. The underwriting fee is designed to compensate the underwriter for the risk incurred from buying the entire issuance before it has received orders from investors for the bonds. The expenses portion of the spread represents the costs of the underwriter's travel, printing costs, and legal fees.

Sunset staff explored whether requiring more state entities to issue bonds through TPFA could reduce the amount of state funds used to sell bonds. Five universities and one state agency were identified as small volume independent issuers of state bonds. The one agency, the Texas Low Level Radioactive Waste Disposal Authority (TLLRWDA) has not yet issued any bonds. Sunset staff compared the issuance costs and spread of these smallest bond issuers to those of TPFA to determine whether those entities have higher bond issuance costs. An independent bond expert was consulted to ensure the methodology of the comparison was valid.[1] The staff also examined whether consolidations of bond authority would result in more effective bond issuance.

## Findings

▼ **TPFA achieves low bond issuance costs through large volume bond sales.**

- As of September 1, 1995, TPFA had issued nearly $5 billion worth of bonds making it the largest issuer of bonds in the state and the 36th largest issuer in the country.[2] The Authority had issued $2.73 billion in 20 ***general obligation bond*** issues, $1.14 billion in 16 ***revenue bond*** issues, $678.4 million in general obligation **commercial paper** and $121.3 million in revenue commercial paper as of that same date.

- Because TPFA can consolidate bond issues for its existing client agencies, TPFA's average amount of bonds per issue from 1988-1994 was more than three times larger than all issuers of state bonds except for the Texas Water Development Board. As a result, TPFA has at least three times the amount of bonds per issue over which to distribute issuance costs, allowing TPFA to issue bonds at a lower cost per bond.

- TPFA has an efficiency measure within the Appropriations Act for issuance costs not to exceed $2.00 per $1,000 of issuance. In fiscal year 1994, TPFA met its appropriations efficiency measure for 98.16 percent of bond issues. In fiscal year 1995, TPFA met this efficiency measure for all bond issues.

**Key Terms**

**General Obligation (or G.O.) Bonds** - tax-exempt bonds that are legally backed by the full faith and credit of the issuing government. The government is legally obligated to use its full taxing power, if necessary, to repay the debt. In Texas, issuing G.O. bonds requires voter approval.

**Revenue Bonds** - tax-exempt bonds that are legally backed by a specified revenue source of the issuing government. If that revenue source is not sufficient to make debt service payments, the issuer is not legally required to appropriate other revenues to repay the debt. In Texas, revenue bonds only require legislative approval, not voter approval.

**Commercial Paper** - short-term debt with maturities ranging from two to 270 days. At maturity, the issuer can pay off the commercial paper or roll it over into a new commercial paper issue. Commercial paper is often used to finance the portions of construction projects ready at a particular time, rather than financing an entire project at once. The commercial paper can be refinanced into long-term bonds upon completion of the entire project.

**Key Terms**

**Competitive Bid** - a type of bond sale in which the issuer and its financial advisor structure the bond issue, prepare the official statement, obtain a bond rating and publish a bond sale notice. After bids are received, the bonds are sold to the underwriter(s) submitting the lowest interest cost. Competitive bids allow competition between underwriters to drive down the interest rate charged issuers.

**Negotiated Sale** - a type of bond sale in which the issuer works primarily with a syndicate of underwriters to structure a bond issue and sell them on the market. The senior manager of the syndicate also assists in preparing the official statement and obtaining a bond rating. Interest rates on the bonds are negotiated between the issuer and syndicate. Negotiated sales allow underwriters to market the bonds to investors prior to issuance which reduces the amount charged by an underwriter.

- **TPFA's issuance costs are much lower than those of the five universities examined.**

  - As can be seen in the chart, *Comparative Bond Issuance Expenses,* TPFA has issued **competitively bid** *general obligation bonds* considerably less expensively than the five state universities in question. The average cost takes into account the volume of bonds issued by each entity. The average was not shown for **negotiated sales** since TPFA was the only agency of those shown to issue *general obligation bonds* using negotiated sales between 1987 and 1995.

  - The same chart also shows that TPFA has issued *revenue bonds* less expensively per $1,000 of bonds issued. This average also takes into account the volume of bonds issued by each entity.

  - Dollars unnecessarily spent on bond issuance costs are wasted state resources. By reducing the amount of bond issuance expenses, the state can minimize the total amount of bonds needed for any given legislatively authorized project.

- **TPFA has minimized spread (profit) paid to underwriters for state bond issuances better than small bond issuers and has the reputation for minimizing spread in the bond industry.**

  - The chart, *Comparative Bond Issuance Expenses*, also shows that TPFA has issued *revenue bonds* with lower spreads per $1,000 of bonds issued than the two universities using negotiated bonds sales. This average is weighted to take into account the volume of bonds issued by each entity. The average spread was not shown for competitive bids since spread for competitive bids is calculated as part of the interest rate on a bond issuance and cannot be calculated separately.

  - In addition, TPFA is known in the bond industry as consistently achieving low spreads. According to the Bond Buyer, a bond industry trade newspaper, TPFA has the reputation of achieving the lowest possible spreads from the underwriting firms with which it does business.[3]

**Comparative Bond Issuance Expenses**
**1987 - 1995**

| Entity | Average[1] Cost of Issuance for Competitively Bid General Obligation Bonds | Average[1] Cost of Issuance for Revenue Bonds | | Average[1] Spread for Negotiated Revenue Bonds |
|---|---|---|---|---|
| | | Competitive Bid | Negotiated Sale | |
| TPFA | $1.25 | $3.49 | $1.88 | $6.98 |
| TSU | * | ** | $5.90 | $8.35 |
| SFA | $6.25 | $27.15 | $5.68 | $9.00 |
| UNT | $4.23 | $4.73 | ** | ** |
| TWU | $5.18 | $8.26 | ** | ** |
| TLLRWDA | * | ** | ** | ** |
| MSU | $19.81 | $34.91 | ** | ** |

* Did not issue general obligation bonds 1987-1995
** Did not issue revenue bonds using this type of bond sale 1987 - 1995
[1]Averages calculated using total volume of bonds, total cost of issuance, and total spread issued by each entitiy.

▼ **The Legislature has consistently consolidated state bond issuance functions within TPFA.**

- Over the years, the Legislature has consolidated the debt issuance functions of a number of state agencies into TPFA. The list to the right shows the client agencies that use TPFA to issue bonds and the year they were required to use TPFA.

**TPFA Client Agencies**

General Service Commission (1983)
Texas Department of Criminal Justice (1987)
Texas Youth Commission (1987)
Texas Department of Mental Health and Mental Retardation (1987)
Texas Department of Public Safety (1989)
Texas School for the Blind and Visually Impaired (1989)
Texas School for the Deaf (1989)
Texas Workers' Compensation Insurance Fund (1991)
Texas National Guard Armory Board (1991)
Texas National Research Laboratory Commission (1991)
Texas Parks and Wildlife Department (1991)
Texas State Technical College System (1991)
Texas Juvenile Probation Commission (1995)

- In addition, the Texas Constitution establishes a bond issuance consolidation policy for state universities by authorizing the Legislature to designate a single agency to issue bonds on behalf of state universities.[4] Although no single bond issuance agency has been designated for all state universities, bond issuance consolidation for some universities already occurs. For example, the Texas State University System issues bonds on behalf of its member universities and the state's major university systems issue bonds on behalf of their various components.

- **Other independent research has identified possible savings resulting from consolidated bond issuances.**

  - A recent study of Texas state debt management conducted by the Lyndon B. Johnson School of Public Affairs, found that for every one percent increase in the principal amount financed, issuance cost per $1,000 of bonds decreased .216 percent.[5] This finding supports the notion that issuance costs may decrease if the state created larger bond issues through the consolidation of smaller issues.

*State agencies that issue few bonds or in small amounts have substantially higher costs than TPFA.*

### Conclusion

The high per-bond costs of small bond sales wastes state resources by requiring the state to incur and pay back bonded debt that is higher than necessary. TPFA has shown that it consistently issues bonds at a minimized expense to the state. State agencies and universities that issue bonds infrequently and in small amounts have substantially higher expenses than TPFA. By requiring these small bond-issuance agencies to issue through TPFA, the state can take advantage of TPFA's expertise and economies of scale to significantly decrease bond expenses.

# Recommendation

## Change in Statute

- **Consolidate the debt issuance functions of the following agencies into TPFA:**

  - **The University of North Texas,**
  - **Midwestern State University,**
  - **Stephen F. Austin State University,**
  - **Texas Southern University,**
  - **Texas Woman's University, and**
  - **Texas Lower Level Radioactive Waste Disposal Authority.**

This recommendation would require these state entities to have TPFA issue all bonds or commercial paper necessary to fund their legislatively authorized programs. These new TPFA client agencies would still be fully responsible for completion of the projects and administration of those programs. The agency needing bond funds would still make all decisions regarding the project or program. TPFA would only be responsible for arranging the most cost effective means of bond financing and would not have any other authority over those entities or their projects. When a project is approved and ready to be financed, the entity would work with TPFA to arrange bond financing. In most cases, the bonds would be consolidated with other TPFA bond issues to achieve economies of scale. These universities and agency would no longer have to bid-out and contract with bond counsel, financial advisors or underwriters.

Recent attempts have been made to merge some of the remaining independent state universities into one of the existing state university systems. Under this recommendation, the universities listed above would not be consolidated with any state university system but would only be required to have their bonds issued by TPFA.

In addition, current statute requires Texas Lower Level Radioactive Waste Disposal Authority to obtain all rights associated with real estate that is part of a licensed disposal site. This recommendation would provide the Authority with such rights upon payment in full of any bonds issued by TPFA. Until payment in full was made, TPFA would hold title to land used by the Authority.

## Fiscal Impact

Significant savings are anticipated from the consolidated issuance of bonds. The exact amount cannot be determined since the number and amount of legislatively authorized bond issues needed in the future is not known.

An example of estimated savings can be calculated by comparing TPFA issuance costs to the median issuance costs for those above-named entities on a hypothetical $5 million competitively bid revenue bond issue. TPFA's issuance costs for such a bond issue would be about $17,500 while the other entities' median issuance costs would be about $88,500, resulting in savings of about $71,000 on this one bond issue. However, if TPFA were to issue commercial paper and then issue long-term bonds when a more cost-effective amount of bonds could be pooled together, TPFA's issuance costs could be even less, resulting in even more issuance cost savings. In addition, these estimated savings do not include any savings that could result from reduced spread.

If TPFA needs an additional staff member for accounting purposes, the position would be paid from a portion of any revenue bond proceeds issued by TPFA. No impact on the General Revenue Fund would result.

[1] Methodology validation was performed by Austin Tobin, President, Delphis Hanover Corporation.

[2] The Bond Buyer's Municipal Marketplace Directory. Thomson Financial Publishing, Inc. Skokie, IL. Fall 1995.

[3] Angela Shah, *Low Spreads Force Two Firms to Quit Texas Authority Deal*, The Bond Buyer. February 23, 1996, New York, New York.

[4] Texas State Constitution, Article 7, Section 17.

[5] Texas State Debt Management,The University of Texas at Austin Policy Research Project Report, Number 115, The University of Texas, Lyndon B. Johnson School of Public Affairs, 1995.

# Issue 2

## Improve TPFA's Interaction with Client Agencies by Requiring an Early, Plain Language Orientation to the Agency's Bond Issuance Process.

### Background

TPFA currently serves 13 state agencies by issuing bonds on their behalf. During the bond issuance process, significant amounts of data and other support materials are jointly developed by TPFA and the client agency and the two agencies must work together closely. The following material briefly describes TPFA's bond issuance process.

*TPFA must collect extensive information from client agencies to develop a bond issuance.*

Once the Legislature authorizes the issuance of bonds for a TPFA client agency, the client agency contacts TPFA when ready to begin the bond issuance process. TPFA then collects relevant data from the client agency including: the purpose of the bonds; the life and type of the project or program to be financed; a schedule outlining when funds will be needed; and the source of payment for principle and interest. This information is used by TPFA to develop a bond issuance proposal, with the help of its **bond counsel**, **financial advisors** and possibly **bond underwriters**.

When a proposal is ready, TPFA staff presents the request for financing to the TPFA board. The TPFA board reviews and approves the request for financing, selects a method of sale, and ensures that the staff has developed the most cost-effective bond issuance possible. If the TPFA board approves the request and structuring of the bond issue, an application is made to the Bond Review Board (BRB) for approval of the bond issuance. BRB serves as a check to ensure that the state's interests are served by the bonds and that the bond issue does not adversely affect the state's overall debt structure or credit rating.

Once bonds are sold, the bond proceeds are placed in the State Treasury. State agencies must spend these proceeds within time frames established by the Internal Revenue Code to avoid paying **arbitrage** rebates or penalties to the federal government.

**Key Terms**

**Bond Counsel** - a specialized law firm hired by a bond issuer to prepare a legal opinion certifying that the issuer has complied with all legal requirements governing bond issuance. The bond counsel also issues an opinion as to whether the interest paid on the debt will be exempt from federal and state income taxes. Bonds generally cannot be sold in the tax-exempt market without a satisfactory legal opinion.

**Financial Advisor** - a firm hired by the issuer to protect the interests of the issuer during the bond issuance process. The financial advisor also helps the issuer make decisions such as how to structure the debt, whether or not to negotiate the sale of the bonds or use a competitive bid process, and when to sell the bonds to minimize the interest rate.

**Bond Underwriters** - investment banking companies that purchase whole bond issues from issuers and then resell pieces of that bond issue to investors at a profit.

**Arbitrage** - the profit made when money from the sale of bonds is invested at a higher interest rate than the interest rate paid on those bonds. The Tax Reform Act of 1986 established regulations to prevent governmental entities from issuing bonds solely for the purpose of earning arbitrage, including establishing time frames in which bond proceeds must be spent.

State agencies need to ensure that the services they offer are readily available and easy to understand; otherwise, clients using these services may not benefit from them to the greatest extent possible. The review examined TPFA's efforts to prepare client agencies for the bond issuance process.

## Findings

▼ **Inadequate communication between TPFA and its client agencies complicates the bond issuance process.**

- Although client agencies believe TPFA does a good job in structuring bond issuances more effectively and cheaply than they could, the agencies are sometimes frustrated with the bond issuance process due to a lack of orientation information on that process.[1] Client agencies felt this lack of orientation contributed to problems such as: miscommunication between the client agencies and TPFA; client agencies' failure to understand and meet the various requirements of the bond issuance process; providing the wrong type of information to TPFA; and wasted staff time.

- Bond issuance requires a good deal of knowledge related to bond underwriting, the Internal Revenue Code, market fluctuations and economic principles. As a result, bond issuance is a highly technical topic and can be confusing and difficult to understand, especially for agencies with little or no bond-related experience. Most of TPFA's client agencies have little bond financing experience. Client-agency staff that deal with TPFA in issuing bonds are typically accounting, budget or facility construction staff that have little or no direct exposure to the mechanics of bond issuance.

- TPFA indicated that incomplete project planning by client agencies can inhibit its effective planning of a bond issuance. In addition, client agencies often change staff responsible for working with TPFA, further complicating the process. Client agencies also have a responsibility to fully orient TPFA to the projects slated for bond financing and the staff that will be responsible for the projects.

- **Improving TPFA's orientation process would benefit both agencies.**

    - Having TPFA client agencies better understand the bond issuance process will help eliminate any confusion or miscommunication those agencies may encounter and, as a result, improve the process. Enhancing initial communication will also help ensure that project planning and timing of bond financing best serve the needs of both agencies.

    - Providing client agencies with an accurate understanding of the bond issuance process helps those agencies plan the staff time and resources necessary for the bonding process. This planning will help ensure that the agency's primary functions are met while still efficiently progressing through the bond issuance process.

    - Having TPFA client agencies accurately understand bonding process requirements is essential to receiving quick and reliable bond-related information from those agencies. That information is used to develop the best possible bond deal for the client agency and the state.

*Enhancing communication between TPFA and client agencies will improve project planning and timing of bond financing.*

- **Other agencies have recognized the importance of providing plain-language material to make complicated agency functions and processes understood.**

    - The Texas Workers Compensation Commission must provide plain-language information packets to injured workers who enter the workers' compensation system process. Such packets help ensure that injured workers understand their rights in a very complicated system.

    - The Texas Department of Insurance (TDI) produces numerous information brochures in simple and clear terms so that the insurance industry is more easily understood by policy holders. In addition, the Insurance Code requires TDI to develop standard insurance policy forms in plain language.

*TPFA's process for interaction with client agencies needs improvement.*

## Conclusion

The bond issuance process is complex and difficult to understand. Since TPFA's client agencies often do not have bond issuance expertise, easy to understand information on that process is essential to ensure that the bond issuance process can progress quickly and efficiently. TPFA's current process for interaction with client agencies needs improvement.

# Recommendation

## Changes in Statute

- **Require TPFA to develop an orientation to the bond issuance process for client agencies that includes:**
  - **plain language information explaining the bond issuance process; and**
  - **an orientation meeting held before the bond issuance process begins.**
- **Require TPFA client agencies, as part of the orientation process, to provide TPFA with detailed project information, legislative authorization, and a list of staff designated to work with TPFA on the project.**

## Management Action

- **TPFA should provide a comprehensive, non-technical orientation on the bond issuance process, particularly for agencies without significant bond issuance experience. The orientation materials should include:**
  - **a basic time line explaining the steps in the bond issuance process from legislative authorization to the payment of debt service;**
  - **definitions of commonly used terms in the bond issuance process;**
  - **a description of the role of each participant in the bond issuance process including, but not limited to TPFA, the Bond Review Board, the Comptroller's Office, the Attorney General's Office, financial advisors, bond counsel, and bond rating companies;**
  - **a list of the basic information/documentation needed by TPFA and other participants in the bond issuance process, including examples when appropriate;**
  - **TPFA and Bond Review Board rules; and**
  - **a general description of any key Internal Revenue Service requirements of which client agencies should be aware.**

These recommendations will lay the groundwork for TPFA's client agencies to effectively work their way through the bond issuance process. A full discussion of TPFA's expectations and information needs will allow TPFA to proceed at the pace necessary to sell bonds at the most appropriate time, while allowing the agencies to determine the necessary staff time and resources to meet TPFA's needs.

## Fiscal Impact

No significant fiscal impact will result from this recommendation.

[1] Sunset staff meeting with TPFA client agencies, April 18th, 1996.

# Issue 3

## Continue the Texas Public Finance Authority for 12 Years.

### Background

The Texas Public Finance Authority (TPFA) was created in 1983 as the Texas Public Building Authority to issue tax-exempt *revenue bonds* on behalf of the General Services Commission. In 1987, TPFA began issuing tax-exempt *general obligation bonds*. Over the years, 12 additional entities have been required to have TPFA issue bonds on their behalf. These entities, along with the year they were required to issue bonds through TPFA, are shown on page 11 of Issue 1.

*TPFA issues bonds on behalf of 13 state agencies.*

Over time, the TPFA statute has undergone other significant changes. In 1989, TPFA began administering the Master Lease Purchase Program. This program uses tax-exempt **commercial paper** and *revenue bonds* to finance the purchase of equipment and small capital improvements at interest rates below commercially available rates. TPFA can also issue up to $50 million of *revenue obligations* to finance alternative fuels infrastructure projects and the conversion of state and local government fleet vehicles from conventional to alternative fuels.

In a Sunset review, continuation of an agency and its functions depends on certain conditions being met, as required by the Sunset Act. First, a current and continuing need should exist for the state to provide the functions or services. In addition, the functions should not duplicate those currently provided by any other agency. Finally, the potential benefits of maintaining a separate agency must outweigh any advantages of transferring the agency's functions to another agency. The evaluation of the need to continue the Texas Public Finance Authority and its functions led to the findings discussed in the following material.

## Findings

**Key Terms**

**Commercial Paper** - short-term bonds with maturities ranging from two to 270 days.

**Issuance Costs** - fees and expenses paid to bond consultants for legal and financial advisory services, as well as fees for document drafting and printing, travel, and other bond related expenses.

**Spread** - the profit made by an underwriter involved in selling a particular bond issue.

**Underwriter** - intermediaries between bond issuers and investors. Underwriters purchase whole bond issues from issuers and resell pieces of that bond issue to investors at a profit.

▼ **The functions of the Texas Public Finance Authority (TPFA) continue to be needed to provide experienced and cost-effective access to financial markets to fund state agency capital needs.**

- TPFA is an experienced issuer of state debt. TPFA has successfully issued over $4.6 billion worth of state bonds in about 40 separate issues, making it the largest issuer of bonds in the state and the 36th largest issuer in the nation.[1]

- TPFA is a cost-effective state bond issuer because it can consolidate bond issues for its client agencies. The chart *Current Texas State Bond Issuers*, on page 8 in Issue 1 shows that, except for the Water Development Board, TPFA's average amount of bonds per issue from 1988-1994 was more than three times larger than the next largest issuer of state bonds. As a result, TPFA has at least three times the amount of bonds per issue over which to distribute **issuance costs**, allowing TPFA to issue bonds at significantly lower costs per bond.

- TPFA has an efficiency measure within the Appropriations Act for issuance costs not to exceed $2.00 per $1,000 of issuance. In fiscal year 1994, TPFA met its appropriations efficiency measure for 98.16 percent of bond issues. In fiscal year 1995, TPFA met this efficiency measure for all bond issues.

- Because of TPFA's sustained presence in the bond market, it has been successful in minimizing the amount of **spread** paid by the state to bond **underwriters**. TPFA has negotiated spreads a low as $2.50 per $1,000 of bonds issued. Such low spreads have earned TPFA the reputation of achieving some of the lowest possible spreads in the bond industry.[2] In addition, TPFA has achieved low spreads while obtaining favorable interest rates.

*TPFA has successfully issued over $4.6 billion of state bonds in 40 separate issues.*

- TPFA issues revenue commercial paper or bonds in its Master Lease Purchase Program (MLPP) to make low cost financing available to state agencies for the acquisition of equipment and small capital improvements at interest rates below that offered by vendors. The interest rate charged to state agencies through MLPP is between two and 10 percent below rates available from commercial vendors.

▼ **Abolishing TPFA would result in numerous uncoordinated bond issuances by state agencies which would result in each agency duplicating financial procedures for virtually identical tasks.**

- If TPFA were abolished, each of the 13 agencies issuing bonds through the Authority would have to develop their own procedures to issue bonds including: evaluating bids for, and hiring, financial advisors, bond counsel and underwriters; structuring bond issuances and approving the timing of the bond sale; and accounting for and making debt service payments. Such duplication would result in separate and uncoordinated contracts by the client agencies for virtually equivalent activities. All benefits gained by having TPFA issue these bonds together would be lost.

*Abolishing TPFA would result in client agencies issuing separate, uncoordinated contracts for bond issuance services.*

▼ **No substantial savings or other benefits would result from transferring TPFA functions to another agency.**

- TPFA plays a major role in the state's bond issuance activities. Although other agencies issue bonds, no other agency addresses the financing concerns of multiple state agencies. For example, the University of Texas System, the Texas A&M System, the Texas Water Development Board, the Texas Department of Housing and Community Affairs, and the Texas Veterans Land Board all issue significant amounts of bonds. However, these agencies only issue bonds for activities related to that agency, not on behalf of other agencies. In addition, as discussed in issue one, these agencies frequently issue a large enough volume of bonds so that no financial advantage would result from combining them with TPFA.

- The Bond Review Board (BRB) has expertise in bond issuance, but primarily functions as an oversight body to ensure the will of the Legislature is carried out concerning the issuance of bonds for state capital projects. BRB is also responsible for reporting the bond issuance activity of all state entities to the Legislature each year. Combining TPFA with the BRB would result in the oversight agency approving its own bond deals, which would reduce the effectiveness of BRB's oversight. Furthermore, unlike TPFA which deals solely with state agencies, BRB is also responsible for overseeing the bond issuances of local governments.

▼ **Four of the five most populous states have some form of bond issuance consolidation.[3]**

- Besides Texas, three of the five most populous states consolidate bond issuance in some fashion. In New York, the State Comptroller's Office issues all *general obligation bonds*. In Pennsylvania, the Office of Budget issues all *general obligation bonds*. In Florida, the Bond Finance Division issues all state bonds. Among the five most populous states, only California does not have some form of bond issuance consolidation and individual state agencies issue their own debt.

*TPFA effectively uses economies of scale to achieve low issuance costs for the bonds they sell.*

### Conclusion

TPFA effectively provides debt financing for the 13 state agencies required by the Legislature to use TPFA. As the largest issuer of state debt, TPFA takes advantage of economies of scale to achieve lower issuance costs for the bonds they sell. Although other state agencies and universities issue bonds, TPFA is the only agency structured to consolidate the bond issuances of multiple entities and pay debt service on those bonds. No other agency was identified that could more effectively provide such services.

# Recommendation

## Change in Statute

■ **Continue the Texas Public Finance Authority for 12 Years.**

This recommendation will result in TPFA having a new Sunset date of September 1, 2009.

### Fiscal Impact

If the Legislature continues the functions of the Texas Public Finance Authority using the existing organizational structure, the Authority's annual appropriation of about $600,000 would continue to be required for the operation of the agency. However, since the money used to fund the Authority comes from revenue bond proceeds, this appropriation would have no effect on the General Revenue Fund.

[1] The Bond Buyer's Municipal Marketplace Directory. Thomson Financial Publishing, Inc. Skokie, IL. Fall 1995.

[2] Angela Shah, *Low Spreads Force Two Firms to Quit Texas Authority Deal*, The Bond Buyer. February 23, 1996. New York, New York.

[3] Texas State Debt Management, The University of Texas at Austin Policy Research Project Report, Number 115, The University of Texas, Lyndon B. Johnson School of Public Affairs, 1995.

# ACROSS-THE-BOARD RECOMMENDATIONS

| Texas Public Finance Authority | | |
|---|---|---|
| **Recommendations** | **Across-the-Board Provisions** | |
| | **A. GENERAL** | |
| Apply | 1. | Require at least one-third public membership on state agency policymaking bodies. |
| Apply | 2. | Require specific provisions relating to conflicts of interest. |
| Apply | 3. | Require that appointment to the policymaking body be made without regard to the appointee's race, color, disability, sex, religion, age, or national origin. |
| Update | 4. | Provide for the Governor to designate the presiding officer of a state agency's policymaking body. |
| Apply | 5. | Specify grounds for removal of a member of the policymaking body. |
| Apply | 6. | Require that information on standards of conduct be provided to members of policymaking bodies and agency employees. |
| Apply | 7. | Require training for members of policymaking bodies. |
| Apply | 8. | Require the agency's policymaking body to develop and implement policies that clearly separate the functions of the policymaking body and the agency staff. |
| Apply | 9. | Provide for public testimony at meetings of the policymaking body. |
| Modify | 10. | Provide for notification and information to the public concerning agency activities. |
| Modify | 11. | Require the agency to comply with the state's open meetings law and administrative procedures law. |
| Apply | 12. | Require development of an accessibility plan and compliance with state and federal accessibility laws. |
| Apply | 13. | Require that all agency funds be placed in the treasury to ensure legislative review of agency expenditures through the appropriations process. |
| Modify | 14. | Require information to be maintained on complaints. |
| Apply | 15. | Require agencies to prepare an annual financial report that meets the reporting requirements in the appropriations act. |
| Apply | 16. | Require development of an equal employment opportunity policy. |
| Apply | 17. | Require the agency to establish career ladders. |
| Apply | 18. | Require a system of merit pay based on documented employee performance. |

| Texas Public Finance Authority | |
|---|---|
| **Recommendations** | **Across-the-Board Provisions** |
| | **B. LICENSING** |
| Not Applicable | 1. Require standard time frames for licensees who are delinquent in renewal of licenses. |
| Not Applicable | 2. Provide for timely notice to a person taking an examination of the results of the examination and an analysis, on request, to individuals failing the examination. |
| Not Applicable | 3. Authorize agencies to establish a procedure for licensing applicants who hold a license issued by another state. |
| Not Applicable | 4. Authorize agencies to issue provisional licenses to license applicants who hold a current license in another state. |
| Not Applicable | 5. Authorize the staggered renewal of licenses. |
| Not Applicable | 6. Authorize agencies to use a full range of penalties. |
| Not Applicable | 7. Specify disciplinary hearing requirements. |
| Not Applicable | 8. Revise restrictive rules or statutes to allow advertising and competitive bidding practices that are not deceptive or misleading. |
| Not Applicable | 9. Require the policymaking body to adopt a system of continuing education. |

# BACKGROUND

# Background

## Agency History

In 1983, the 68th Legislature created the Texas Public Building Authority for the purpose of issuing tax-exempt ***revenue bonds*** on behalf of the General Services Commission (GSC). The bond proceeds were used by GSC to acquire, construct, or renovate office space. Since its creation the Authority's enabling statute has undergone several changes which are briefly outlined below.

In 1987, the 70th Legislature passed the Texas Public Finance Authority Act that changed the name of the agency to the Texas Public Finance Authority (TPFA) and expanded its authority to include issuing ***general obligation bonds***.

- In 1989, TPFA was authorized to issue *revenue bonds* to finance the purchase of equipment under the Master Lease Purchase Program (MLPP).
- In 1991, the Authority's Board membership was increased from three members to six members.
- In 1993, TPFA authority was expanded to provide bond financing to both state agencies and local governments for alternative fuels conversions and alternative fuels infrastructure projects.

Since creating TPFA, the Legislature has steadily increased the number of agencies required to use TPFA for bond issuance. Currently, TPFA issues bonds on behalf of 12 state agencies and one institution of higher education. The chart to the right lists those agencies and the year they were required to issue bonds through TPFA.

**TPFA Client Entities**

General Services Commission (1983)
Texas Department of Criminal Justice (1987)
Texas Youth Commission (1987)
Texas Department of Mental Health and Mental Retardation (1987)
Texas Department of Public Safety (1989)
Texas School for the Blind and Visually Impaired (1989)
Texas School for the Deaf (1989)
Texas Workers' Compensation Insurance Fund (1991)
Texas National Guard Armory Board (1991)
Texas National Research Laboratory Commission (1991)
Texas Parks and Wildlife Department (1991)
Texas State Technical College System (1991)
Texas Juvenile Probation Commission (1995)

**Key Terms**

**<u>Revenue Bonds</u>** - tax-exempt bonds that are legally backed by a specified revenue source of the issuing government. If that revenue source is not sufficient to make debt service payments, the issuer is not legally required to appropriate other revenues to repay the debt. In Texas, revenue bonds only require legislative approval, not voter approval.

**<u>General Obligation (or G.O.) Bonds</u>** - tax-exempt bonds that are legally backed by the full faith and credit of the issuing government. The government is legally obligated to use its full taxing power, if necessary, to repay the debt. In Texas, issuing G.O. bonds requires voter approval.

## Policymaking Structure

The Texas Public Finance Authority is governed by a six-member Board whose members serve staggered six-year terms. Board members are appointed by the Governor, with advice and consent of the Senate. The Governor appoints the chair from the Board membership. The statute does not specify specific qualifications for Board members.

The TPFA Board has six primary duties:

- develop and review bond financing for state agencies' capital projects;
- issue bonds for those projects;
- select consultants as needed for the issuance of bonds;
- hire the agency's Executive Director;
- establish rules for administration of the Act; and
- set policy for the Authority's operation.

The TPFA board is required by statute to meet at least quarterly, and usually meets once a month. Board members are reimbursed for costs incurred as a result of their duties and receive a $30 per diem for each day spent performing board functions.

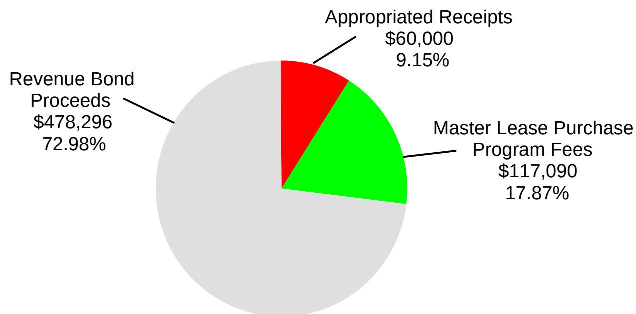
## Funding and Organization

### FUNDING

TPFA is funded from three sources: *revenue bond* proceeds, appropriated receipts, and MLPP administrative fees. The agency receives no funding from the sale of *general obligation* bonds or from the General Revenue Fund. The chart, *Sources of Revenue for Administration - Fiscal Year 1995*, shows the dollar amount TPFA received for administration from each funding source. These revenue sources support the agency's three appropriations strategies.

*TPFA receives no funding from the General Revenue Fund.*

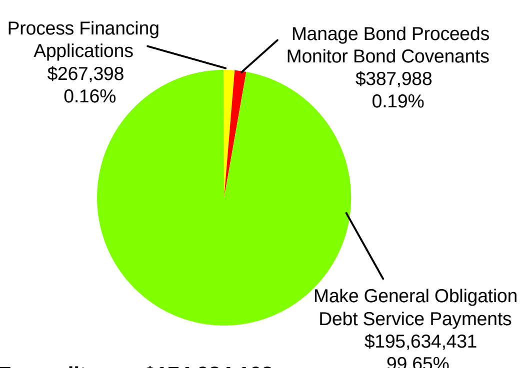
**Sources of Revenue for Administration**
**Fiscal Year 1995**




**Total Revenues: $655,386**

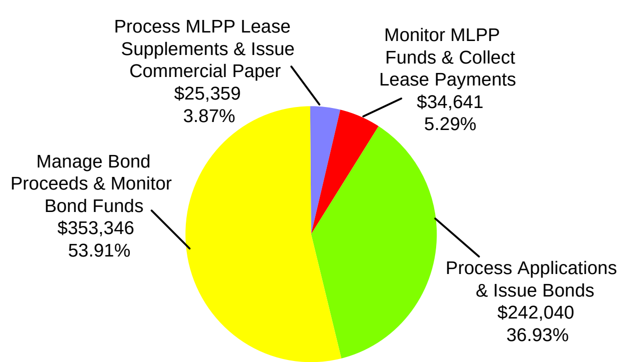
The chart, *Expenditures by Strategy - Fiscal Year 1995*, shows a breakdown of the agency's total expenditures for each strategy. The chart, *Expenditures for Administration - Fiscal Year 1995*, shows a breakdown of the agency's expenditures by administrative activity.

**Expenditures by Strategy**
**Fiscal Year 1995**




**Total Expenditures: $174,984,102**

**Expenditures for Administration**
**Fiscal Year 1995**




**Total Expenditures: $655,386**

| TPFA Purchases from HUBs Fiscal Year 1995 | |
|---|---|
| Total Purchases of Goods and Services | $923,421.66 |
| HUB Purchases Reported by GSC | $98,466.37 |
| Percentage | 10.663% |
| Adjusted HUB Purchases per TPFA | $108,371.47 |
| Adjusted Percentage | 11.743% |
| Statewide Average | 15.89% |
| State Goal | 30% |

The Legislature has established a statewide goal of 30 percent of all agency contracts be made with Historically Underutilized Businesses (HUBs). The Legislature also requires the Sunset Commission, in its reviews, to consider agencies' compliance with laws and rules regarding HUB use. The Chart, *TPFA Purchases from HUBs - Fiscal Year 1995*, shows TPFA's HUB participation in fiscal year 1995.

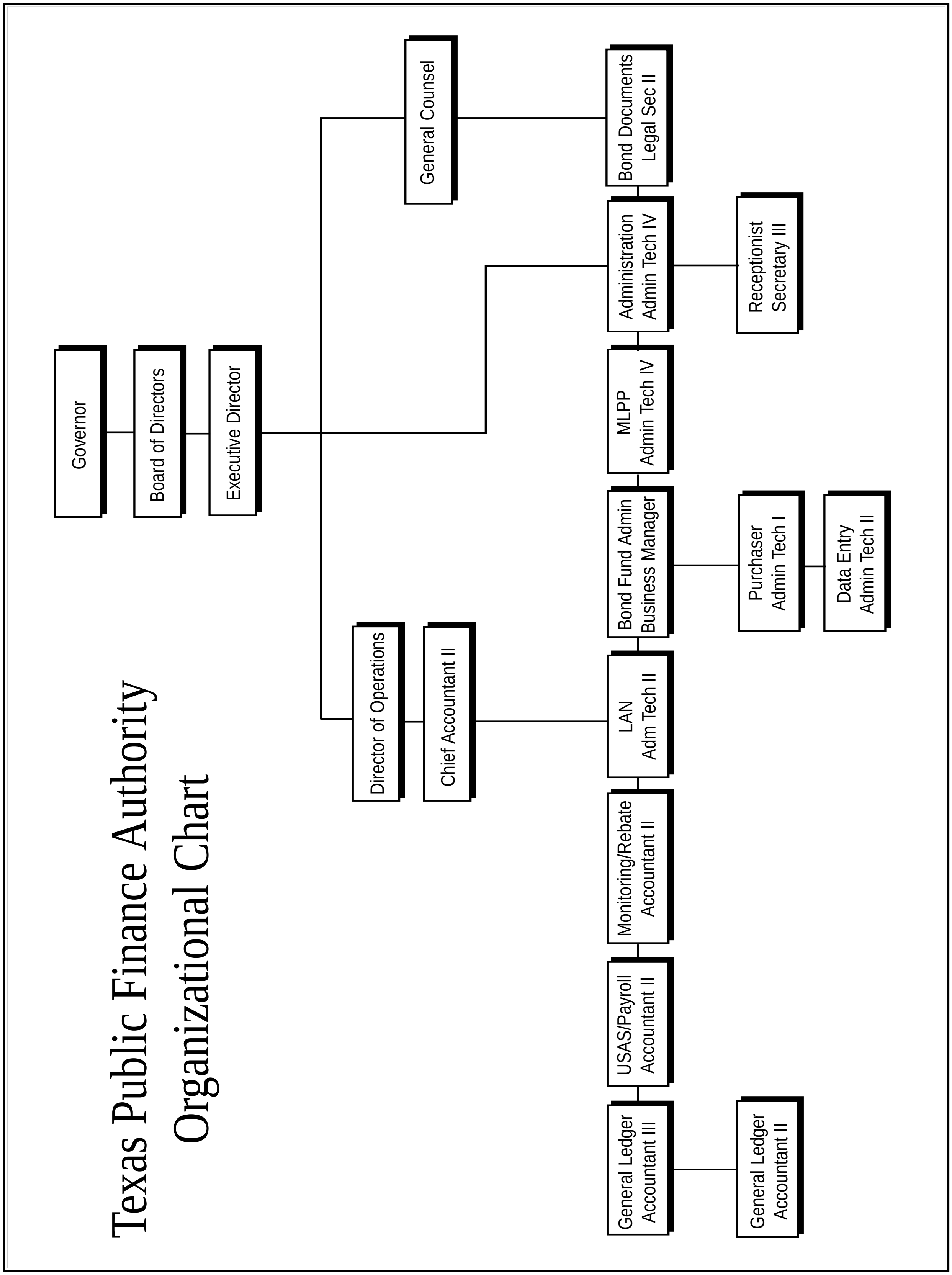
The chart shows expenditures as reported by the General Services Commission (GSC) and adjusted figures supplied by TPFA. The adjusted totals are included to provide a more accurate picture of TPFA's use of HUB's. In its enabling statute, TPFA is required to make a good faith effort to use HUB in the issuance of at least 30 percent of its bonds. However, fees to HUB investment banking firms used toward the 30 percent goal are not included in GSC's calculations. Adding these expenditures results in a better percentage to compare to the state's average.

## ORGANIZATION

TPFA had a staff of 14 full-time equivalent employees in fiscal year 1995. All of TPFA's employees are located at the agency's office in Austin. The organizational structure of TPFA is illustrated in the chart, *Texas Public Finance Authority Organizational Chart*. A comparison of the agency's workforce composition to the state's minority workforce goals is shown in the chart, *Texas Public Finance Authority Equal Employment Opportunity Statistics - 1995.*

**Texas Public Finance Authority**
**Equal Employment Opportunity Statistics - 1995**

| Job Category | Total Positions | Minority Workforce Percentages | | | | | |
|---|---|---|---|---|---|---|---|
| | | Black | | Hispanic | | Female | |
| | | Agency | State Goal | Agency | State Goal | Agency | State Goal |
| Officials/Administration | 3 | 0 | 5% | 0 | 8% | 65.3% | 26% |
| Professional | 6 | 29.2% | 7% | 15.5% | 7% | 60.1% | 44% |
| Technical | NA | 0 | 13% | 0 | 14% | 0 | 41% |
| Protective Services | NA | 0 | 13% | 0 | 18% | 0 | 15% |
| Para-Professionals | 2 | 0 | 25% | 0 | 30% | 100% | 55% |
| Administrative Support | 3 | 37.5% | 16% | 0 | 17% | 62.6% | 84% |
| Skilled Craft | NA | 0 | 11% | 0 | 20% | 0 | 8% |
| Service/Maintenance | NA | 0 | 19% | 0 | 32% | 0 | 27% |


Texas Public Finance Authority
Organizational Chart
Governor
Board of Directors
Executive Director
General Counsel
Director of Operations
Chief Accountant II
Bond Documents
Legal Sec II
Administration
Admin Tech IV
Receptionist
Secretary III
MLPP
Admin Tech IV
Bond Fund Admin
Business Manager
Purchaser
Admin Tech I
Data Entry
Admin Tech II
LAN
Adm Tech II
Monitoring/Rebate
Accountant II
USAS/Payroll
Accountant II
General Ledger
Accountant III
General Ledger
Accountant II

## Agency Operations

The Texas Public Finance Authority has one strategic goal that reflects its overall operation — provide financing for capital projects and equipment. The strategies to obtain this goal, and the performance measures for those strategies are discussed below.

### Application Processing

*TPFA's mission is to provide financing for legislatively approved capital projects and equipment.*

TPFA's first strategy is to process applications for debt financing submitted by client agencies. Once a client agency receives legislative approval to issue bonds to finance a project, it contacts TPFA to begin the bond issuance process. TPFA staff then acquire information relating to the bond issuance from the client agency to begin structuring financing for the project or program. This information includes:

- a citation of the statute authorizing the client agency to issue bonds;
- a brief description of the purpose of the bonds;
- a citation of the legislative authorization for the project;
- a resolution from the requesting agency's board authorizing request for financing; and
- an analysis of the project to be financed, including an estimated time frame and cost of the overall project and a technical description of the project including the intended construction method and the proposed materials for use.

TPFA staff, along with its financial advisor and bond counsel, use this information and any necessary supplemental information provided by the client agency to prepare a financing package to present to the TPFA Board for approval. This package includes a project analysis, a funds expenditure schedule, and a recommendation on the method of sale. The staff package does not comment on the appropriateness of the project. For more information on the underwriting process, see the text box on page 36.

If a bond financing package is approved by the TPFA board, staff then completes an application for Bond Review Board (BRB) approval, as is required for all state issued municipal bonds. BRB serves as a check to ensure that the state's interests are served by the bonds and that the bond issue does not adversely affect the state's overall debt structure or credit rating. If BRB approves the TPFA financing application, TPFA can proceed with the sale of bonds.

In fiscal year 1995, TPFA developed 12 requests for client agency financing, including MLPP issues for equipment financing resulting in $300. million in bond issuance. TPFA also refinanced $359.3 million of previously existing debt in fiscal year 1995.

*In fiscal year 1995, TPFA developed 12 requests for financing totaling over $359 million.*

## Bond Management and Debt Service

TPFA also has two strategies relating to paying debt service and ensuring **bond covenant** compliance. The first strategy pertains to monitoring all bond covenants and paying debt service on both r*evenue and general obligation* bonds. The second strategy appropriates funds used to pay debt service on *general obligation bonds* only.

To manage proceeds from bond sales, the State Treasury creates several new bond funds. Generally, a bond issue requires the creation of four bond funds:

- the cost of issuance fund - created to cover costs incurred in connection with developing a bond issue. These can include payment for financial advisor and bond counsel as well as printing documents and travel costs;
- the project fund - created to pay costs associated with the actual project, such as construction expenses;
- the interest and sinking fund - created to provide for principal and interest payments; and
- the rebate fund - used, if necessary, to pay any rebates or penalties to the Internal Revenue Service (IRS) for failure to meet arbitrage requirements.

Additional funds may be established depending on the complexity of the bond issue. In addition, accounts within the project fund can deal with specific expenditures of funds.

Once the Treasury receives the bond proceeds, the client agency can request to draw those proceeds from the TPFA project fund within the Treasury. TPFA then verifies that the amount requested is available and transfers that amount to client agency funds within the Treasury. The client agency then uses the proceeds to pay for goods and services provided by vendors to complete the project.

**Key Terms**

**Bond Covenant** - a formal debt agreement between bond holders and bond issuers stipulating the terms of the bond purchase.

**Debt Service** - the combination of interest and principal due on a bond.

**Paying Agent** - a company, usually a bank, which keeps track of who owns an issuer's bonds as the bonds are traded. The paying agent then receives funds from the bond issuer to pay principal and interest to the bond holders.

# The Underwriting Process[1]

Bond underwriters are intermediaries between issuers and investors. Most investors cannot afford to buy whole **bond issues** from an issuer and most issuers do not have the time or resources to market bonds to multiple investors. Underwriters fill the void in the marketplace by purchasing whole bond issues from issuers and then reselling bits and pieces of that bond issue to investors, ideally at a profit.

Sometimes underwriters form syndicates. A syndicate is a temporary group of underwriters who purchase bonds from the issuer under the direction of a senior or lead manager. The senior manager directs negotiations with the issuer and helps coordinate the bond sale. Syndicates vary in size depending on the amount of the issue and the ease with which the bonds sell. Syndicates are often made up of large national underwriters and smaller regional underwriters to help ensure marketing of the bonds to a wide variety of potential investors. In addition, the syndicate often brings together firms that specialize in either sales to large institutional investors, such as pension funds, or direct sales to individual investors.

Issuers sell bonds to underwriters primarily two ways, by negotiated sale or competitive bid. In a negotiated sale, an issuer usually works with an underwriting syndicate. The composition of the syndicates assembled by TPFA is based on factors such as each firm's expertise, previous dealings with TPFA, financial resources, operating presence in Texas, and the number of women and minorities employed. The senior manager of the syndicate will assist the issuer in determining what amount of bonds will mature in a particular year (known as structuring the bond issue), preparing the **official statement** and obtaining a bond rating. Bond ratings are further discussed on page 41. The syndicate will also engage in pre-sale marketing of the bonds, and then will negotiate interest rates with the issuer. Negotiated sales are most common with revenue-bond issues.

In a competitive bid bond sale, the issuer, with the assistance of its financial advisor and bond counsel, structures the debt, prepares the official statement, verifies legal documents, obtains a bond rating, secures **credit enhancement**, if necessary, and decides the best time to go to market to sell the bonds. The issuer then advertises a notice of sale which describes the issue, lists the sale date, and identifies the amount of principal to mature at various years throughout the life of the bond. On the day of the sale, the underwriters submit sealed bids to the issuer indicating the interest rates they are willing to pay for each of the maturities. The rates can vary for bonds with different **maturity dates** but must be the same for bonds with the same maturity date. The issuer then evaluates the bids and selects the underwriter or syndicate submitting the bid that results in the lowest interest costs.

During the past few years, debate has occurred over which type of bond sale is better. Historically, one of the main arguments against using negotiated sales has been the belief that negotiated sales result in higher costs to the issuer. However, the growth of the municipal bond market during the 1980's has narrowed the difference between the average underwriter's **spread** for bonds sold through a negotiated sale versus bonds sold through competitive bid.

**Key Terms**

**Bond Issue** - a group of bonds issued for the same purpose by one issuer. Each bond issue is composed of subsets of bonds with varying maturity dates. Each bond with a different maturity date will have a different interest rate.

**Official Statement** - a document that describes the issuers ability to make payments of principle and interest on bonds.

**Credit Enhancement** - tools used by bond issuers to raise the rating of a bond issue by reducing the risk to investors. Examples of credit enhancement tools include insuring the bonds against default, and letters of credit, where a bank agrees to make payments on behalf of an issuer for a specified period of time.

**Maturity Dates** - the date on which the principal of the bond must be repaid. Until this date, periodic interest payments are usually made.

**Spread** - the profit made by underwriters. For a more detailed discussion of spread see Issue 1.

Experts do not agree on which type of bond sale results in lower interest costs. Some people believe a competitive bid results in lower interest costs since underwriters have an incentive to bid as low as possible to be awarded the bonds. However, others argue that the flexibility associated with a negotiated sale, i.e. being able to change the date of the sale and the structure of the bonds to better meet investor demands, and the pre-sale marketing by the underwriters, may result in lower interest rates.

Although no definitive answer exists as to which type of sale is better, some general guidelines have evolved to help issuers decide on the type of sale to use. Competitive bids sales tend to be more common with *general obligation bonds*, while negotiated sales are more common with *revenue bonds*, especially when the issue amounts are large or involve creative or complex bond structuring techniques. Examples of other factors to consider include how often the issuer goes to the market, the need to time the sale to take advantage of market conditions, and whether the bonds will be used to refund existing bonds.

[1] This section is based on information obtained from the World Wide Web site of the Texas Comptroller's Office located at http://www.window.state.tx.us/

TPFA pays **debt service** on *revenue bonds* issued on behalf of client agencies by collecting lease payments from client agencies and transferring the money to the appropriate fund within the Treasury. The Treasury authorizes TPFA to direct the transfer of funds within the State Treasury and to make disbursements to **paying agents** for debt service on each *revenue bond* issued on behalf of a client agency.

Paying debt service for *general obligation bonds* is handled the same way as debt service for *revenue bonds*, except TPFA is directly appropriated funds for this purpose rather than receiving lease payments from client agencies.

In fiscal year 1995, TPFA completed 3,813 financial transactions including interfund transfers and debt service payments. Also in fiscal year 1995, TPFA was appropriated $198.5 million for *general obligation bond* debt service and spent $143.9 million for *revenue bond* debt service payments. The agency also managed 130 funds created for bond proceeds associated with 40 debt issues.

## Master Lease Purchase Program

TPFA is responsible for administering the state's Master Lease Purchase Program (MLPP) created in 1989. The purpose of the program is to finance small capital improvements, or to purchase capital equipment for state agencies by taking advantage of the state's high bond rating and ability to issue tax-exempt debt. By financing such items through MLPP, the state avoids higher financing costs charged by vendors. State agency participation in MLPP was mandatory during the fiscal 1992-1993 biennium. MLPP must be used if an agency chooses to lease-purchase eligible items unless the agency can prove there is a lower cost alternative.

For a purchase or capital improvement to qualify for MLPP financing, it must have a useful life of at least three years and a total value of at least $10,000. Individual prices of equipment costing less than $10,000, such as individual desktop computers, can be bundled into a package to meet the $10,000 minimum. Any MLPP purchase with a term of longer than five years or with a purchase price of over $250,000 must be approved by the Bond Review Board. Examples of eligible MLPP-financed purchases include automobiles, computers, computer software, machinery, and heavy equipment. Building construction can be financed through MLPP if the amount financed is too small to make the issuance of long-term bonds cost effective.

To participate in MLPP, agencies must enter into a master lease agreement with TPFA each biennium. The master lease agreement authorizes TPFA to issue tax-exempt state debt to finance the lease-purchase of eligible capital items. For each individual purchase an agency wishes to make through MLPP, the agency certifies that it has appropriated funds available to make lease payments in the current biennium and will seek lease payment appropriations in any subsequent biennium if necessary.

TPFA issues revenue commercial paper to finance the cost of the items purchased through MLPP. The proceeds from the sale of the commercial paper are used to pay vendors for the MLPP-eligible items. Currently, the variable MLPP interest rate is approximately 3.5 percent. However, TPFA charges participating agencies 5.5 percent to ensure that variations in the commercial paper interest rates are covered in the lease payments paid by participating agencies. If the actual interest cost is less than 5.5 percent TPFA rebates any excess interest collected back to participating agencies six months after payment is due. This rebate is usually applied to the next MLPP lease payment required from the agency. TPFA also charges participating agencies an administrative fee of one percent of the outstanding balance for operating MLPP. While a participating agency makes lease-purchase payments to TPFA, TPFA holds title to any equipment purchased through MLPP. Once payment has been made in full, title conveys to the purchasing agency.

*Items eligible for MLPP financing include cars, computers, software, machinery, heavy equipment and, in some cases, building construction.*

Although MLPP provides financing of eligible items, it does not affect General Services Commission (GSC) purchasing regulations. As a result, any MLPP purchases fall under the same GSC rules and guidelines as any non-MLPP purchase. Each agency must therefore follow the GSC bid rules and HUB goals when making purchases through MLPP. During fiscal year 1995, TPFA administered 1,195 MLPP contracts for 50 state agencies resulting in payments of over $38.5 million.

### Other Programs

In 1993, the 73rd Legislature established a state financing program to encourage state agencies and local governmental entities to improve air quality by converting fleet motor vehicles to alternative fuels. TPFA was authorized to issue up to $50 million of *revenue obligations* to finance fleet conversion projects approved by the Alternative Fuels Council (AFC). However, the Attorney General's Office raised a concern that statute creating the program did not specify a means of repaying the bonds. This problem was corrected by the Legislature in 1995.

Because of the delay resulting from concerns over bond repayment and other factors, no state agency or local entity has yet taken advantage of the available financing. AFC is now promoting AFP through a series of press releases and letters in hopes of informing eligible agencies and authorities of the program. Currently, two municipalities have expressed an interest in participating.

# APPENDIX

# Appendix 1

## Bond Rating

Much of the debt issued by governments is rated by private, independent bond rating companies. These rating companies are: Moody's Investors Service, Standard and Poor's Corporation and Fitch's Investors Service. Although bonds do not legally require a rating, the market requires issuers usually have much of their debt rated by one, or some combination of the three rating companies so that investors can analyze the degree of risk associated with purchasing bonds. The higher the bond rating the lower the risk to investors and therefore the lower interest rate for the bond.

Bonds are classified into two types for rating purposes - short and long-term bonds. Short-term bonds cannot have a maturities longer than four years. Long-term bonds have maturities lasting longer than four years. Commercial paper — short-term notes with maturities less than 270 days — is usually rated on a separate scale from other short term bonds.

The three rating companies examine essentially the same four major credit factors when determining municipal bond ratings. These major credit factors are the government's economy, debt, administration, and fiscal/financial performance.

A strong economy with high employment levels and a strong tax base usually indicates a viable revenue base. Viable revenue streams translate into a high ability to repay bonds. As a result, strong economic variables result in high bond ratings.

A government's debt history and current debt situation are also examined in rating a bond. If a government has successfully paid-off previous bonds then rating companies will associate less risk with the issuing government which will result in a higher bond rating. In addition, they examine the government's current debt to revenue ratio and debt per capita to determine the issuer's ability to pay back principal and interest of the bonds. High per capita debt or a high debt to revenue ratio means a government may have trouble repaying bonds. As a result, the better the government's debt history and the more revenue available to payoff bonds, the higher the bond rating.

Rating companies also examine the professionalism and ability of government officials to address issues that impact the creditworthiness of the government. They scrutinize factors such as the organization of the government, whether or not adequate services are being provided, intergovernmental relations, and administrative performance. The rating companies also inspect the availability and quality of financial documents such as budgets, annual financial reports and capital improvement plans. Generally, the better organized a government is, the higher the bond rating.

Finally, bond ratings also depend on fiscal performance factors. Rating companies examine current liabilities and cash flow and revenue and expenditure trends. In addition, rating companies will examine financial audits to determine how successful the government has been in achieving balanced budgets. A cash flow analysis may also be conducted to determine if the issuer's expected revenue intake and outflows leave sufficient funds available to pay the principal and interest on the bonds.

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