

SAM - BUDGETING

LEASE-REVENUE BONDS

6872

(Revised 09/2017)

Lease-revenue bonds are used in the state's capital outlay program to finance projects. The revenue stream paying the debt service on the bond is created from lease payments made by the occupying department to the governmental financing entity which constructs the facility or causes it to be constructed. Generally, this entity is the State Public Works Board (PWB). The governmental financing entity constructs the facility, issues bonds, and retains title to the facility until the debt is retired. PWB's lease-revenue program is described in Section 6873.

Pursuant to the California Constitution, public agencies cannot enter into an indebtedness or liability without voter approval. However, under the Offner-Dean lease exception rule, long-term lease revenue bonds entered into by public agencies are not considered an indebtedness or liability under the debt limit if the lease meets certain criteria.

Nonetheless, bond rating agencies include lease-revenue payment obligations when calculating the state's bonded indebtedness. Thus, there is a distinction between the concept of *California constitutional debt* and *debt as defined by the municipal bond market*.

Key highlights:

1. In contrast to GO bonds, annual appropriations are necessary for rental payments that support lease-revenue debt service. However, the obligation to pay is *not* extinguished if appropriations are not provided.
2. Government Code Section [15848](#) provides for debt service payment in the event of no budget and in certain situations when there is a budget that failed to include an appropriation for debt service.

Generally, lease-revenue bonds pay interest at tax-exempt rates, which are slightly higher than tax-exempt rates for GO bonds.

3. Lease-revenue payments are due if there is "beneficial use and occupancy" of the facility. If all or part of the facility cannot be occupied, the rent will be abated proportionate to that part of the facility unavailable.
4. Lease-revenue bond issuances are sized larger than actual project needs primarily for:
 - a. A capitalized interest account to pay debt service during the construction period until the facility can be occupied and sometimes for a limited post-construction period; and

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- b. A debt service reserve fund. A reserve fund is created by the indenture or trust agreement and is usually funded from bond proceeds. Reserve funds are generally required by rating agencies for bonds other than GO bonds as a prerequisite for investment grade rating. A reserve fund may be used to replenish the interest and principal accounts in case of deficiency or to pay debt service if no other money is lawfully available (i.e. insurance proceeds). Drawing on a reserve fund is absolutely a last resort and is an event frowned upon by the financial markets. The amount of the reserve fund is governed by tax law. Currently, most PWB lease-revenue bonds are secured in part by a pooled master reserve fund.
5. Lease-revenue debt service is structured as level debt payments because the repayment schedule must be similar to that for a commercial operating lease.
6. The term of the bonds cannot exceed the useful life of the facility.
7. Lease-revenue bonds may not be issued for any project for which a lease cannot be created. (Without a legally-enforceable lease, there is no security for the issue.)
8. Lease-revenue projects may require interim financing for costs incurred before the bonds are issued. Interim financing for preconstruction and construction costs generally requires assurance that the loan will be repaid in another manner in the event bonds authorized for the project are not sold. For PWB projects, this is generally in the form of Budget Act language, which authorizes repayment of interim costs from a department's support appropriation.
9. The Department of Finance, the State Treasurer's Office, the department (and in some cases the Department of General Services) all have roles in the successful completion of lease-revenue project financing. For further discussion, see Sections 6873 for PWB lease-revenue bonds, Section 6880 for preparing for a bond sale, and Section 6884 for continuing disclosure. The department responsibilities are summarized in Section 6886.
10. Other lease requirements are set forth in Section 6876.