



June 19, 2007

Honorable Judge Rodney S. Melville  
Superior Court, Santa Maria Division  
312-M East Cook St.  
Santa Maria, CA 93455

Tel: 805.564.5305

Fax: 805.897.1993

City Hall

735 Anacapa St.

Santa Barbara, CA

93101

PO Box 1990

Santa Barbara, CA

93102-1990

**City of Santa Barbara's responses to Fiscal Year 2006-2007  
Grand Jury Report on "Certificates of Participation"**

Dear Judge Melville:

During its regular meeting on June 19, 2007, the City Council adopted the following as the City's response to the relevant findings and recommendations in the Fiscal Year 2006-2007 Grand Jury Report entitled "Certificates of Participation in Public Finance: Is more Scrutiny Needed?"

The City has made limited use of Certificates of Participation (COP). At this time, the City has only 4 outstanding COP issues. Of the four, three are for City Enterprise Funds (one each for Water, Wastewater and Waterfront). The other COP issue was a combined issue for the General Fund and the Golf Fund (also an Enterprise Fund). In all cases, the COP were issued for bona fide long-term capital improvements that were first carefully reviewed as part of the City's Six-Year Capital Improvement Plan (CIP). Enterprise Fund projects included in the Six-Year CIP are reviewed by one or more of the City's boards or commissions, comprised of citizens appointed by the City Council. For example, the Water Commission, comprised of five citizens appointed by the City Council, reviews and makes recommendations to the Council on the Six-Year CIP for both the City's Water and Wastewater Enterprise Funds. The Water Commission is also asked to review and approve any plans to issue COP to fund specific Water/Wastewater capital projects, including the projected impact on rates and budgets. The Water Commissions recommendations on both the Six-Year CIP and any proposed COP issue are forwarded to the City Council. All meetings of the Water Commission are publicly noticed with specific and well identified agendas in full accordance with the state Ralph M. Brown Act.

The City believes that review by boards and commissions, the City Council's Finance Committee and the full City Council, each at one or more publicly-noticed meetings provides citizens with ample opportunity to comment on both specific capital projects as well as any COP financing plan.

***Finding #1:***

*Projects funded by COPs are not subject to a well-regulated, mandatory public notice process, and this deficiency can preclude the general public from either registering opposition or participating as investors.*

**Response:**

The City respectfully disagrees with this finding. Issuance of COP requires approval of the City Council in at least one publicly-noticed meeting. This is true whether the COP being issued are to provide “new money” for projects or solely a refinancing to take advantage of lower interest rates. For “new money” issues, the City always identifies the specific projects to be included in the financing. Also, projects to be financed are generally taken from the City’s Six-Year Capital Improvement Plan which has already undergone extensive public review through the budget process. As an example, the process leading to the issuance of the City’s 2004 Sewer Revenue COP included several publicly noticed meetings including with the City’s Water Commission and the City Council’s Finance Committee to review the list of projects to be included in the financing. That COP financing plan, including the specific projects, was then reviewed again by the full City Council in a public hearing prior to approval of the COP issuance.

In most cases, there is also a whole other level of preliminary review prior to a public decision by the City Council. Most of the City’s COP are issued on behalf of one of the City’s Enterprise Funds (Water, Wastewater, Waterfront, etc.). In each case prior to being reviewed by the City Council and its Finance Committee, the financing plan is reviewed by the appropriate City Board or Commission. For example, COP issued by the City’s Water and Wastewater Enterprise Funds are reviewed by the Water Commission. COP issued on behalf of the City’s Waterfront Fund are reviewed by the Harbor Commission. This is an additional level of publicly noticed review provided by citizens that have been appointed by the City Council.

The City believes that its existing review process, including review by the appropriate boards and commissions and the standard, state-required public noticing procedures for Finance Committee and City Council meetings are sufficient to provide the public with notice of plans to issue COP, the projects to be financed and the projected impact on rates and budgets.

***Recommendation #1:***

*A consistent, mandatory public notice and approval process should be implemented and sale of COPs should not proceed until completion of that process.*

**Response:**

The City believes that a mandatory public noticing process already exists and does not believe that additional mandatory public notice and approval process is required or needed. As stated above, the City believes that the existing process of public review by

boards and/or commissions, the City Council's Finance Committee and the full City Council, all at publicly-noticed meetings, offers the public sufficient notice and opportunity for comment.

***Finding #2:***

*Taxpayers and/or investors may be at risk if standard assurances (e.g. environmental and "escrow") are not consistently required prior to issuance of COPs.*

**Response:**

The City agrees that this is a true statement. However, at least in the City's case, standard assurances such as escrows are required by the professionals retained by the City to assist in the issuance. For example, bond counsel, the investment banking firm (the underwriter), the independent City's financial advisor - as well as the City's Finance and City Attorney staff - are all charged with making sure that the structure of the deal complies with all laws, regulations and standard practices, protecting both the City and the investors who purchase the City's COP.

***Recommendation # 2:***

*All projects funded by COPs should receive the necessary assurances that are demanded of projects funded by General Obligation and Revenue Bonds.*

**Response:**

The City agrees with this recommendation but believes that this is already the case. The City's process for including a project in a COP issue is the same as it is for issuance of a General Obligation or Revenue bond. As mentioned above, the City's capital projects, including those funded by COP, are reviewed as part of the City's Six-Year Capital Improvement Program which is reviewed by the City's various Boards, Commissions, the City Council Finance Committee and the full City Council. Any reallocation of COP proceeds to other projects is also approved by the City Council. As an example, attached to this report is a list of the Wastewater projects included in the City's most recently issued COP. As the attachment indicates, of the \$18.5 million of projects funded, \$16.5 million was for major upgrades to the City's El Estero Wastewater Treatment Facility. The other \$2 million was for improvements to problems areas of the City's wastewater collection system.

***Finding #3:***

*The maturity terms of COPs are often comparable to those (20-30 years) for General Obligation and Revenue Bonds, suggesting that COPs may be an inappropriate substitute for such bonds.*

**Response:**

The City agrees that the maturity terms of COP are almost always comparable to those of General Obligation and Revenue bonds. This is certainly true of the City's COP. However, the City respectfully does not agree that this suggests that COP may be an

inappropriate substitute for such bonds. COP are generally not a good choice for short-term financing because the transaction costs do not make this a cost-effective option. The general rule is that the term of the financing should approximate – or certainly not exceed – the useful life of the assets being acquired, constructed or improved. In the City’s case, COP are used only for bona fide long-term capital improvements. Therefore, it is appropriate that the term of the COP be generally matched to the life of those improvements. This also allows the cost of the project to be equitably matched to the expected useful life of the improvement.

***Recommendation #3:***

*The use of COPs should be restricted to short-term projects. Long-term projects should be funded with General Obligation or Revenue Bonds.*

**Response:**

The City respectfully disagrees with this recommendation and will not be implementing this recommendation. The City believes that COP are a legitimate vehicle for financing long-term capital improvements and that terms of up to 20 or 25 years is not unreasonable as long as the term of the COP does not exceed the expected useful life of the asset being acquired, constructed or improved.

***Finding #4:***

*The regulations regarding the sales of COPs and the use of the proceeds from those sales are inadequate.*

**Response:**

The City respectfully disagrees that the regulations regarding the sales of COP and the use of the proceeds are inadequate. While the finding may reference the public noticing requirements, the actual issuance of COP is a highly regulated process that generally takes several months. In addition, the process is subject to substantive state and federal law requirements.

***Recommendation #4:***

*COPs should be sold only as needed to fund the specific project for which they were approved, and the funds should not be used for other projects. In particular, COPs should not be sold for the sole purpose of earning interest on the funds.*

**Response:**

The City agrees that COP should not be sold for the sole purpose of earning interest on the funds. In fact, doing so would violate state and federal tax law which flatly prohibits tax-exempt COP (or any other tax-exempt debt) being issued for the sole purpose of earning interest on the proceeds (referred to as “arbitrage”). Even when COP are issued for valid governmental purposes, tax-exempt issuers are limited in the amount of investment income that can be earned and kept on tax-exempt proceeds of debt. The City,

like all other tax-exempt issuers, is required to perform annual “arbitrage rebate” calculations and to rebate to the federal government any “excess” investment income earned from investment of the COP proceeds. Therefore, it is not legally possible to issue COP solely for the purpose of earning arbitrage investment income.

The City respectfully disagrees that COP proceeds should never be reallocated to projects that were not specifically identified prior to the issuance and will not be implementing this recommendation. In almost every case, the City uses COP proceeds only for projects identified prior to the COP issuance. However, there are occasions where circumstances that were unforeseen at the time of issuance result in a change in priorities after COP issuance. The law and rules governing the use of COP proceeds do allow the City to reallocate unspent COP proceeds to any qualifying capital project. In addition, the security for any particular COP issuance would be absolutely unaffected by a reallocation. The City believes this flexibility is appropriate. Reallocation of unspent COP proceeds must be approved by the City Council and must be for a bona fide capital project for the same operation for which the COP were issued. In addition, the original contracts creating the COPs must also provide for this flexibility, as it typically does and as the COP investor is aware.

***Finding #5:***

*Districts and government agencies are not required to give notification of the use of COPs to County or city governments which might be affected.*

**Response:**

The City agrees that districts and other government agencies are not required to give notification of the use of COP to County or city governments which might be affected. Because there are a very limited number of independent districts within the City, this has not been a problem. Moreover, because the City and County do not exercise fiscal oversight over the other nor could the City have any possible financial or legal obligation for non-City COPs, notification from the County (or from a district) of any plans to issue COP would not be meaningful or necessary.

***Recommendation #5:***

*Any district or government agency within the County that is planning to issue any COPs should give notification to the County government and any affected municipal government.*

**Response:**

The City respectfully disagrees with this recommendation and does not plan to implement this recommendation. As stated above, there are a very limited number of independent districts within the City. Therefore, this has not been a problem and such a rule would not provide the City with any meaningful ability to influence financing plans of other governmental agencies. The same is true of any plans by the County to issue COP

because the City and the County do not have any fiscal oversight responsibility over the other or fiscal obligations to each other with respect to COPs.

The City of Santa Barbara would like to thank the Grand Jury for its Report on “Certificates of Participation.”

Sincerely,

James L. Armstrong  
City Administrator

Attachment:  
Wastewater COP-Funded Projects and Estimated Costs

cc: Grand Jury Foreperson

**Attachment**

**Wastewater COP-Funded Projects and Estimated Costs**

<b>Projects</b>	<b>Estimated Cost</b>
El Estero Treatment Plant Projects	
Construction of Replacement Digester Mixing System	\$ 1,970,000
Construction of new Thickened Sludge Pump Station	2,900,000
Installation of additional (fourth) Influent Pump	1,365,000
Rehabilitation of the Secondary Clarifiers	1,470,000
Reconfiguration and rehabilitation of the Aeration Basins	1,625,000
Rehabilitation of the Primary Clarifiers	1,875,000
Replace 3 existing influent pumps	2,925,000
Rehabilitate Thickener Air Scrubbers	1,250,000
Rehabilitate the Headworks Air Scrubbers	1,120,000
Collection System Wet-Weather Capacity Improvements	2,000,000
<b>Grand Total</b>	<b>\$ 18,500,000</b>