**Backgrounder: Alternative Funding Methods for School District General Obligation Bonds**

Over the past decade, the San Diego County Taxpayers Association (SDCTA) has been heavily involved in the review of Proposition 39 general obligation bonds. These efforts have included: two studies reviewing the effectiveness of Independent Citizens Oversight Committees (ICOCs) and various procurement delivery methods, the development of the SDCTA ICOC Best Practices, the SDCTA Procurement Best Practices, and the SDCTA Bond Support Criteria Process and Application.

School districts that have recently passed bond measures have experienced an unanticipated drop in assessed value of homes in their districts. This has negatively impacted the ability to issue bonds to pay for infrastructure projects. Due to the loss in assessed valuation following the start of the recession, districts are approaching or have hit their respective property tax limits authorized by voters without issuing all of the debt that has been authorized.\(^1\) Districts are unable to issue these remaining “authorized, but unissued” bonds because taxes would have to be raised above their authorized limit in order to pay for them.

This inability to issue bonds creates an environment in which districts must either halt their bond programs, find bridge financing to keep bond programs alive, or use more expensive debt-financing mechanisms in order to issue debt while staying below their taxing authority. Some districts are also reviewing options to go back to voters to increase tax rates to continue construction programs.

**How Typical General Obligation Bonds Work**

Following the voter approval of a school bond measure, a school district will typically prepare a series of bond sales to finance construction of the projects promised to voters. The measure that is passed by voters allows the district to impose a tax on properties to finance the debt. Section 15270 of the California Education Code states that, for a single election, tax rate levies must not exceed $30 per $100,000 of assessed valuation (AV) for elementary districts; $60 per $100,000 AV for unified school districts; and $25 per $100,000 AV for community college districts.

School districts have the ability to issue bonds under the Education Code or Government Code, both of which outline the legally permissible maturities of bonds. Education Code Section 15264 states districts cannot issue bonds with a maturity greater than twenty-five (25) years. Under Government Code Section 53508, a school district can issue bonds that have a maturity up to forty (40) years. The issuance of debt is constructed in a way so as to not exceed the tax rate cap approved by voters. Recently, school districts have been moving away from traditional financing mechanisms such as Current Interest Bonds.

**Current Interest Bonds**

Under a Current Interest Bond (CIB), interest is paid to bondholders semiannually and principal is paid upon maturity. The length of maturity is generally between 25 to 30 years, but legally can be no more than 40 years. The maximum length of maturity does not apply to the date in which voters approve a measure, but begins once a bond is issued. School districts will issue bonds in “series” at different points in time in which the funds are needed to complete projects. The bonds within each series are staggered so that debt service payments do not exceed the revenue generated by the voter authorized tax limits.

**What are Capital Appreciation Bonds?**

Unlike conventional bonds, Capital Appreciation Bonds (CABs) (also known as Zero Coupon Bonds) require a series of deferred payments consisting of accrued interest and principal made to investors. The payments consist of the principal and all unpaid

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\(^1\) Districts that also passed bond measures that “extended the current rate” have also experienced difficulties since they must still pay off past debt and issue new debt, at a tax rate that was not increased.
interest that has accumulated and compounded for a period of up to 40 years.

By issuing CABs, districts are able to maintain their current taxing level while issuing additional debt in order to raise funds for projects. In order to avoid exceeding this authority and calling another election to increase tax rates, the appeal of deferring debt to future generations while receiving the funds today may entice districts to use this type of financing.

The following are two examples of school districts within San Diego County that have recently issued CABs. It is unclear exactly how many school districts have issued CABs in the past.

Figure 2 outlines the debt service schedule for a $105 million CAB – Series B bonds issued by the Poway Unified School District (PUSD) in August 2011 for its Proposition C program passed by voters in 2008. Between 2011 and 2032, PUSD is not required to pay any debt service toward this bond issuance. In total, the cost of the $105 million bond issuance is approximately $982 million over the 19 year period, which means the district is going to be paying $877 million in interest.

Figure 3 outlines the debt service schedule for a $30 million CAB – Series B bonds issued by the Oceanside Unified School District (OUSD) in May 2010 for its Proposition H program passed by voters in 2008. Between 2011 and 2033, OUSD is not required to pay any debt service toward this bond issuance. In total, the cost of the $30 million bond issuance is approximately $280 million over the 20 year period, which means the district is going to be paying $250 million in interest.

Comparison of Costs

Recently an analysis comparing the cost of issuing a series of bonds as Current Interest Bonds versus Capital Appreciation Bonds outlined the potential difference in costs to a district (Figure 4). If the district were to issue CABs, while taxpayers would be charged $10 less per $100,000 of assessed valuation, they would be paying an additional $1 billion in debt service costs on the bonds.

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**Figure 4: Comparison of CIBs vs. CABs**

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<tr>
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<th>Current Interest Bonds</th>
<th>Capital Appreciation Bonds</th>
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<tbody>
<tr>
<td><strong>Total Bond Issuance</strong></td>
<td>$538,000,000</td>
<td>$538,000,000</td>
</tr>
<tr>
<td><strong>Projected Tax Rate</strong></td>
<td>$22</td>
<td>$12</td>
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<tr>
<td><strong>Total Bond Payback Period</strong></td>
<td>39 Years</td>
<td>52 Years</td>
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<tr>
<td><strong>Total Bond Debt Service</strong></td>
<td>$993,508,450</td>
<td>$1,902,898,350</td>
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**Bond Reauthorization**

One alternative being considered by districts to continue bond programs (other than delaying the sale of bonds or issuing CABs) is the idea of going back to voters for a bond reauthorization.

A reauthorization involves a district going back to request an increase to the tax rate to pay off the remaining unissued bonds already authorized by voters in a past election. The total amount of bonds to be sold would not be increased. Rather, tax rates would be increased again to pay off the debt that has yet to be issued.

Figure 5 outlines a hypothetical district in which voters approved a $30 million bond measure, and the district has so far issued $18 million in bonds. The district thus has $12 million in authorized, but unissued bonds. As mentioned previously, districts are bound by tax rate limitations for each election in which voters approve a bond measure. That limitation only applies to one election so voters can approve another increase during a different election. Thus, voters have the ability to increase tax rates a second time to allow the district to reauthorize bonds.

If the district decides to seek voter approval to reauthorize the remaining unissued bonds, voters would not only allow that authorization, but they would also approve the decertification of the existing authorized but unissued bonds to prevent the issuance of additional debt.

**Figure 6: District Board Decertifieds Old Authorization**

Finally, if voters approve, the district would then have $12 million in reauthorized bonds that can be issued at a new tax rate above that which was originally approved by voters.
Figure 7: New Bonds under Voter Approved New Tax Rate

This approach is an alternative to issuing long-dated CABs with high debt service costs.

**SDCTA Recommendation**

On August 8, 2012, the SDCTA Board of Directors adopted the following principle as it relates to school district’s use of Capital Appreciation Bonds:

“SDCTA opposes the use of Capital Appreciation Bonds with maturities greater than 25 years as a financing mechanism for General Obligation bonds because of the increased debt burden on taxpayers. CABs with maturities of 25 years or less should only be pursued if it can be demonstrated that its use will result in less debt service than other financing instruments. Other financing options that should be compared to the potential use of CABs include voter approved tax increases, including voter approved bond reauthorization. Defensible assumptions for growth in assessed value shall be used for development of any proposed financing method.”