

# *De La Rosa Bulletin*

*April 7, 2009*

## ***State of California Update: GO Bonds, Capital Spending, Budget Deficits and Cash***



On March 24, the State of California sold \$6.5 billion of general obligation (GO) bonds. This was the State's first GO sale in more than nine months. Although the State usually sells GO bonds five to six times a year, budget problems and the delay in addressing them had kept the State out of the market. The enactment of the February 20 budget set the stage for the new bond issue, but the budget and the bond sale do not entirely resolve the circumstances that have created cash pressures on the State and forced the suspension of spending on thousands of capital projects.

### **What is the Pooled Money Investment Board?**

When the TV cameras showed up at a meeting of the Pooled Money Investment Board (PMIB) December 17, this "obscure" (to use the journalists' favorite word) State agency was thrust front and center into the budget debate. Because of the cash pressures created by the lack of a balanced budget, the PMIB stopped capital spending on 5,300 projects (worth \$18 billion) to be financed with State bonds.

What does the PMIB have to do with bonds? In 1986, when Congress enacted stringent arbitrage and rebate rules for tax-exempt bonds, the State responded with a law to simplify the process, as well as provide greater flexibility to make funding available for projects when needed. The law (AB 55) enables the PMIB to make loans for capital projects from the Pooled Money Investment Account (PMIA), which is the huge cash pool the State maintains that includes General Fund money as well as funds for hundreds of special funds. The loan

program functions like a line of credit, giving agencies the flexibility to draw down funds as needed for projects. The loans are repaid when the State issues bonds.

As 2008 drew to a close, the State's budget imbalance and its inability to issue bonds put dual pressures on the PMIA. According to a report from PMIB staff, "AB 55 loans now are competing for the same shrinking PMIA pot of money that the General Fund is using for State operations. In addition to General Fund operations, the California Constitution and State statutes require the State to maintain cash sufficient to meet the day-to-day operating needs of agencies funded by special funds." It then concluded, "The combined cash demands of the General Fund, the special funds and AB 55 loans cannot be met absent a solution to the budget crisis and restoration of the State's ability to access the bond market."

Accordingly, the PMIB (made up of the Treasurer, Controller and Director of Finance) froze most AB 55 funding. The affected projects included many for which local agencies had advanced funding and expected to be reimbursed from AB 55 draws.

Just before the March bond sale, the PMIA had unreimbursed AB 55 loan expenditures of \$6.02 billion, the highest balance ever. Of this, \$3.83 billion was for tax-exempt GO expenditures. The rest was primarily for taxable GO bonds (\$1 billion) and lease revenue bonds. The \$6.54 billion raised in March will repay \$3.87 billion of tax-exempt AB 55 loan expenditures and provide about \$2.67 billion of additional funds to apply directly



to projects. Further, the Treasurer has announced that the State will sell \$634 million of lease revenue bonds and \$3 billion of taxable GO bonds in April. A portion of the taxable GO bonds are expected to be “Build America Bonds” (BABs). (With BABs, the State would finance tax-exempt GO projects with taxable bonds and receive a reimbursement from the federal government of 35% of the interest cost.) These upcoming sales should permit the repayment of most of the \$6 billion of outstanding PMIA loans and provide about \$3.2 billion for projects.

These bonds sales, while important in re-starting projects, will not provide the necessary funding to reverse entirely the December freeze. This is partly because the bond proceeds used to reimburse the PMIA do not need to be used for projects. They can, instead, be reserved for other cash needs of the State. To date, the PMIB has released only \$1.15 billion of the AB 55 loans subject to the freeze. The Department of Finance posted a list of projects to which these funds and the \$2.67 billion raised in March will be applied ([www.dof.ca.gov/funding\\_released/](http://www.dof.ca.gov/funding_released/)).

In its report to the PMIB before the Board’s April 6 meeting, staff stated that, “Given the increase in project funding provided by the GO bond sales, and the need to preserve PMIA liquidity to help the State cope with projected cash shortfalls, staff recommends the Board not approve additional AB 55 loan disbursements at this time.” The Board approved the recommendation. Further, to avoid the freeze that has proven so disruptive in recent months, PMIB staff further stated an intention “to develop a project financing plan that reduces reliance on AB 55 loans from the PMIA and maximizes upfront funding with GO and lease revenue bond sale proceeds.” Future project spending, including un-freezing projects halted in December, is likely to be more closely tied to the timing of the State’s bond issues than in the past.

If the PMIB decision is based largely on the State’s cash situation, what is the status of the State’s budget and cash?

### **The Budget and Cash**

On February 20, Governor Schwarzenegger signed the State budget for the 2009-10 fiscal year more than four months early. With budgets typically enacted months late, this early enactment changes the typical schedule of budget-related events.

Normally, the governor releases the proposed budget in January followed by a revision to the budget (the “May Revise”) in the second week of May. The May Revise reflects economic forecasts and revenue projections updated from those on which the January budget was based. With an enacted budget in place, will there be a May Revise this year?

The answer is yes, although it will be delayed until after the May 19 special election. That election includes three ballot propositions that are part of the enacted budget, but require voter approval to be implemented. The most important is approval to issue securities backed by revenues of the State lottery, which is budgeted to provide \$5 billion in the 2009-10 budget year. The other two involve the use of about \$835 million of funds previously earmarked by voters for First 5 and mental health programs.

The May Revise must be released by June 8. It will reflect the results of the election (making adjustments if any of the propositions fail) and updated projections of revenues and expenditures since the forecasts incorporated in the February budget. Those forecasts were made at the end of 2008. Since then the economy has slowed more than anticipated and the Legislative Analyst released a report in early March projecting that 2009-10 revenues will be about \$8 billion less than anticipated in the budget. Therefore, although there is an enacted budget, the May Revise is likely to call for adjustments that could again lead to legislative delays in addressing the problem.



Irrespective of any required budget adjustments, the State will face a pressing need for cash as soon after the new fiscal year begins. Based on the February 20 budget, the Department of Finance anticipates the State will end the current fiscal year on June 30 with \$6.9 billion of cash and borrowable resources. (The State meets some of its General Fund cash needs by borrowing from special funds held in the PMIA, thus the pressure to preserve PMIA resources by not lending them for AB 55 loans.) Contrast this with \$12.8 billion the State had at the end of the last fiscal year. Since July and August are months where the State receives relatively little revenue compared to its expenditures, it will need to address its cash needs immediately, probably with short-term borrowing.

For those local governments that wait to size and sell their TRANs until the State releases the May Revise, the late delivery of the May Revise may push back those sales. At the same time, the State's need to sell a short-term borrowing no later than early in the next fiscal year, may compress the time local issuers can sell without being in the market at the same time as the State.

In all, the February 20 budget anticipates a need to borrow \$13.2 billion for cash purposes by November. The May Revise may incorporate developments that would push this number higher since the current projection doesn't reflect updated

revenue projections (such as the \$8 billion of deterioration projected by the Legislative Analyst) and assumes voters approve all the ballot propositions. At the same time, of course, the May Revise will propose solutions to any such developments, so the net cash needs of the State reflected in the May Revise may be smaller or larger than \$13.2 billion.

With such great cash needs, the State will continue to take steps to preserve cash and increase borrowable resources. The February 20 budget made \$2 billion of funds borrowable that were not available previously to the General Fund. This was in addition to several steps already taken since early 2008 to delay certain payments and make certain funds borrowable that had already made available many billions of dollars of cash for the General Fund. Even so, the Department of Finance noted after passage of the February 20 budget that "it may be necessary to continue delaying some payments this year and early into the next fiscal year."

#### **What's Next?**

Watch for:

- Special election May 19
- May Revise release June 8

***For further information or questions, please contact De La Rosa & Co. at (415) 495-8863 in San Francisco or at (310) 207-1975 in Los Angeles.***

*The information contained herein is based on sources that De La Rosa & Co. believes to be reliable, but may neither be all-inclusive nor guaranteed by DLR, and it may be incomplete or condensed. DLR, in presenting the facts and condition of the State's finances, capital spending and or budget deficits involved in the budget, is not expressing an opinion but presenting the facts for informational purposes only. DLR may make a market in or trade for its proprietary account securities discussed in this update. Also, DLR may have been a manager or co-manager of a public offering of municipal bonds or other debt discussed within the last three years for issuer named herein. DLR, its managing partners, directors and employees individually, or their family members, may have either long or short positions in the securities mentioned, and may purchase or sell these securities from time to time in the open market or otherwise for their own accounts or accounts of others.*

*DLR is a municipal investment banking company providing a range of products and services to both the State of California and its municipalities. It is one of the most active underwriters in the State, completing 620 California issues from 2000 to 2008 that provided more than \$100 billion for public projects. DLR is headquartered in Los Angeles and has a regional office in San Francisco.*