HOUSE
RESEARCH
ORGANIZATION bill analysis | 5/16/2007

SB 968
West (Chisum)
(CSSB 968 by W. Smith)

SUBJECT: Financing tools for certain obligations for public improvements

COMMITTEE: County Affairs — committee substitute recommended

VOTE: 7 ayes — W. Smith, Bolton, Coleman, Farabee, Harless, Heflin, Leibowitz

0 nays

2 absent — Naishtat, T. Smith

SENATE VOTE: On final passage, April 19 — 31-0, on Local and Uncontested Calendar

WITNESSES: (*On House companion bill, HB 2276 by Chisum:*)
For — Robert M. Collie, Andrews Kurth LLP; Robert Floyd, Citigroup Corporate + Investment Banking

Against — None

On — Philip Aldridge, UT System; Tom Griess, Office of the Attorney General; Terry Hull, UT System; Donald Lee, Texas Conference on Urban Counties

BACKGROUND: Government Code, ch. 1371 is a public finance statute authorizing certain Texas state agencies and local governments to issue variable rate debt obligations and to enter into credit agreements, including interest rate swap agreements, to manage interest rate risks and support payment of the obligations for infrastructure improvements.

Government Code, sec. 1201.002 defines "issuer" as:

- an agency, authority, board, body politic, department, district, instrumentality, municipal corporation, political subdivision, public corporation, or subdivision of this state; or
- a non-profit agency acting for or on behalf of one of those entities.

Local Government Code, ch. 271, subch. I, provides the procedures for adjudications of claims in county or state courts arising under written

contracts with local government entities. A local governmental entity that enters into a contract subject to this subchapter waives sovereign immunity to suit in a claim for a breach of contract, but awards are limited to the balance due, amount owed for change orders, and interest.

Local Government Code, ch. 271, subch. C establishes procedures for issuing certificates of obligation, which are debt obligations issued by a municipality, county, or hospital district for a term not to exceed 40 years in anticipation of future tax collections and/or revenues.

Local Government Code, sec. 271.049 requires notice to be given, in a newspaper of general circulation, at least two weeks before a local governmental entity intends to issue certificates of obligation. The notice must state:

- the time and place set for authorizing the issuance of the debt;
- the maximum amount and purpose of the debt; and
- the manner in which the certificates will be paid for, whether by taxes, revenues, or a combination of the two.

The entity is not authorized to issue the certificates if a petition is signed by at least 5 percent of the registered voters of the issuer in protest of the obligation.

Government Code, ch. 1251 requires counties and municipalities to hold an election before issuing bonds to be paid for through ad valorem taxes. This chapter also specifies the requirements for proposition and ballot details, the conduct of the election, and public notice.

Government Code, sec. 1202.007 exempts governmental entities from having to get an obligation issuance approved by the attorney general and recorded by the comptroller under certain circumstances.

DIGEST: SB 968 would allow a "credit agreement" to include authorization by a governing body in anticipation of, or related to, some or all of an issuer's obligations or interest on obligations. This bill would refer to "credit agreement" instead of "an interest rate lock, interest rate hedging agreement, or other credit agreement" as part of the financing of a payment.

The bill would add to the definition of an "eligible project" one that was approved by a majority of the voters but for which no debt obligation had been issued or for which there was other indebtedness payable from ad valorem taxes.

The bill would define an "interest rate management agreement" to include swap, basis, forward, option, cap, collar, floor, lock, or hedge transactions. The term would include:

- a master agreement providing standard terms for transactions;
- agreements to transfer collateral as security for transactions; or
- a confirmation of transactions.

The bill would add to the definition of "issuer" the description of an issuer in Government Code, sec. 1201.002 as one that had:

- a principal amount of at least $100 million in outstanding or proposed long-term indebtedness or a combination of both; and
- some amount of the indebtedness that was rated in one of the four highest rating categories for long-term debt instruments by a nationally recognized rating agency for municipal securities, without regard to the effect of any credit agreement or enhancement related to the obligation.

This bill would add to the definition of "obligation" a public security payable from ad valorem taxes if there was voter approval or:

- the issuer was legally authorized to issue public securities payable by ad valorem taxes for this purpose; and
- the issuer had complied with any legal conditions before pledging ad valorem taxes to pay the principal or interest of the obligation.

The bill would add to the definition of "project cost" the interest on the financing of obligations and payments on credit agreements during and after construction.

CSSB 968 would allow an issuer to agree to waive sovereign immunity from suit or liability for the purpose of enforcing the credit agreement or obligation or for damages for breach of the credit agreement or obligation. The following entities would not be allowed to waive sovereign immunity:

- a state agency;
- a state institution of higher education; or
- a county with a population of 900,000 or more.

The bill would require an issuer to have its obligation or credit agreement approved by the attorney general and registered with the comptroller unless exempted by ch. 1202.007 or the obligation or credit agreement matured within one year.

The bill would allow an issuer to execute and deliver any number of credit agreements in anticipation of, related to, or in connection with some or all of the issuer's obligations or interest on obligations, or both, at any time, without regard to whether the obligations had been authorized or issued.

CSSB 968 would require, except in some instances, that a credit agreement would have to substantially contain the terms and period approved by the governing body. A credit agreement could include:

- the ability to be terminated with or without cause; or
- become effective at the option of another party to the agreement, if the governing body found that the option best served the issuer.

The bill would allow the credit agreement costs or payments owed by an issuer under a credit agreement to be paid and secured by any source, including any revenue and money of the issuer or ad valorem taxes, if the credit agreement was authorized in anticipation of, in relation to, or in connection with an obligation that was payable from ad valorem taxes.

The bill would clarify that a credit agreement was an agreement for professional services but not a contract subject to Local Government Code, ch. 271, subch. I.

If a credit agreement was authorized and executed in anticipation of ad valorem taxes as allowed by Local Government Code, ch. 271, subch. C, the bill would require notice to be given and petitions to be considered in accordance with Local Government Code, sec. 271.049, and the issuance and execution would have to be approved at a bond election under Government Code, ch. 1251.

The bill would require that payments received by an issuer under a credit agreement or on termination of a credit agreement be used to:

- pay the obligations or costs associated with that credit agreement;
- pay other liabilities equal or senior to that credit agreement; or
- make payments for any other obligated or financed purpose, unless the credit agreement was paid primarily from ad valorem taxes.

The bill would make Government Code, ch. 1371 a wholly sufficient authority within itself for the execution of a credit agreement or issuing obligations. Further, any restrictions or limitations contained in other laws would not apply to the procedures prescribed by this chapter or to the issuance of obligations, the execution of credit agreements, or the performance of other acts authorized by this chapter.

CSSB 968 would allow an issuer to enter into an interest rate management agreement transaction only if:

- the issuer had either entered into at least three interest rate management transactions before November 1, 2006, or had entered into interest rate management transactions with notional amounts of at least $400 million before that date;
- the governing body had adopted, amended, or ratified a risk management policy within the preceding two years that governed entering into and managing interest rate management agreements;
- the issuer had received from the counterparty, if the transaction had not been awarded through a competitive bidding process, a statement that the difference in basis points fell within the common range for comparable transactions or a statement of another suitable measure of pricing;
- the issuer had received from the counterparty a disclosure of any payments the counterparty made to procure the transactions; and
- the governing body of the issuer had determined that the transaction would conform to the issuer's interest rate management agreement policy after reviewing a report of the chief financial officer of the issuer identifying several indicators of the transaction's worth.

The bill would allow an issuer to agree to pay or receive a payment for early termination of an interest rate management agreement due to a breach or for another reason, and to determine the payment by a specific amount, by a formula, or by a process or algorithm.

CSSB 968 would require the governing body of the issuer to review and ratify or modify its related risk management policy at least biennially, while an interest rate management agreement transaction was outstanding.

The bill would require a governing body that had authorized an interest rate management agreement transaction to designate an officer to monitor the transaction and present a written report at least annually on all outstanding transactions. Issuers that had entered into at least three interest rate management agreement transactions before November 1, 2006, or into transactions with notional amounts totaling at least $400 million before the same date would be exempted from this requirement.

CSSB 968 would allow the governing body to delegate to any number of officers or employees of the issuer the authority to approve specific terms of, to execute and deliver, or to terminate or amend in accordance with its terms, a credit agreement on behalf of the issuer, subject to any conditions placed by the governing body. The delegation, however, would be required to include limits on the principal amount or the notional amount, the term, the rate, the source of payment, the security, the identity or credit rating of an authorized counterparty, and the duration of the authorization. For an interest rate management agreement, the delegation would be required to include limits on the fixed or floating rates, economic consequences, early termination provisions, type, provider, and costs of credit enhancement.

The bill would define a "bond enhancement agreement," as it pertains to higher education finance, as an interest rate swap agreement, a currency swap agreement, a forward payment conversion agreement, an agreement providing for payments based on levels of or changes in interest rates or currency exchange rates, an agreement to exchange cash flows or a series of payments, or other agreement.

CSSB 968 would allow the board of regents of an institution of higher learning to enter into bond enhancement agreements placing an obligation on the board. The bill would require a bond enhancement to contain the terms and conditions for the period of time the board authorized. The bill would allow the fees and expenses for the bond enhancement agreement to be paid from and secured by a lien on and pledge of revenue funds of the board and its institutions, proceeds of the sale of bonds or notes, or from any other source legally available for that purpose. Such payments would

be deemed to be for the support and maintenance of The University of Texas System administration and could be paid from any source.

The bill would allow the board of regents to authorize one or more officers or employees to act on behalf of the board in entering into and determining the counterparty and terms of the bond enhancement agreement as specified by a board resolution. This bill would allow the resolution to authorize a financing program pursuant to more than one bond enhancement agreement.

The bill would specify that, unless specified otherwise by the board of regents or its designee, a bond enhancement agreement was not a credit agreement.

CSSB 968 would require that this section be construed liberally to effect the legislative intent and purposes of this section, and all powers granted by this section should be broadly interpreted to effect that intent and those purposes and not as a limitation of powers.

The bill would take immediate effect if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2007, and would apply only to obligations, credit agreements, or interest rate management agreements adopted on or after that date.

SUPPORTERS SAY:

CSSB 968 would modernize financial tools for issuing public debt. In recent years, many state and local governmental entities successfully have utilized new financing tools to lower interest rates, reduce finance costs, and increase financing flexibility for schools, roads, housing, water, and other public needs. These financing tools can include credit agreements and interest rate swap agreements to address financial risks and support the payment of public debt obligations. Although widely used and allowed by federal and state law, these public finance tools can be complex and could open public entities to abuse by overzealous bankers or financial advisors. To that end, the bill would delineate the proper methods for utilizing these cutting edge financial tools.

The bill would improve the opportunity for public entities to choose the best financing tools, while significantly increasing protections and transparency for public funds. This bill would protect small, less financially experienced entities by requiring issuers to have at least $100

million in existing outstanding debt and an appropriate investment rating before using a more sophisticated financing tool. In addition, the bill would require issuers to adopt risk management policies, monitor interest rate agreements, issue public statements, allow public verification of transaction details and comparable transactions, and have the attorney general approve or deny credit agreements or interest rate swaps. While some would prefer not to grant any governmental entity the ability to waive sovereign immunity, many smaller entities otherwise would be unable to qualify for the very best swap agreements and low-interest rates that currently are offered to larger municipalities and counties. The bill would provide the greatest flexibility in order to ensure the best value for elected officials, policy makers, and taxpayers.

OPPONENTS SAY:

CSSB 968 would open smaller governmental entities to substantial financial risk. Swap agreements depend on having a financial expertise in hedging interest rates, as variable rates fluctuate above or below a standard fixed rate. Inexperienced entities might incorrectly gauge the market and wind up increasing taxpayer costs rather than guaranteeing them through a more traditional credit agreement. While this bill would include various efforts to protect inexperienced governmental entities, complex public finance issues can be well beyond the scope of locally elected officials. This leaves public dollars at peril of being mishandled by unscrupulous bankers.

This bill also would allow governmental entities to waive sovereign immunity, opening these entities to expensive civil litigation. While this bill would not require any entity to waive its rights, financial institutions would have powerful leverage with which to demand that small cities and counties drop their immunity. Realizing the poor bargaining position waiving sovereign immunity would create, state agencies, institutions of higher learning, and counties with 900,000 or more residents would be exempted from this provision. No governmental entity, large or small, should be allowed to waive this essential protection for taxpayers.

NOTES:

The identical companion bill, HB 2276 by Chisum, was reported favorably by the County Affairs Committee on April 25.