



The first five copies of each California State Auditor report are free. Additional copies are \$3 each, payable by check or money order. You can obtain reports by contacting the California State Auditor's Office at the following address:

California State Auditor  
621 Capitol Mall, Suite 1200  
Sacramento, California 95814  
916.445.0255 or TTY 916.445.0033

OR

This report is also available on our Web site at [www.auditor.ca.gov](http://www.auditor.ca.gov).

The California State Auditor is pleased to announce the availability of an online subscription service.  
For information on how to subscribe, visit our Web site at [www.auditor.ca.gov](http://www.auditor.ca.gov).

Alternate format reports available upon request.

Permission is granted to reproduce reports.

For questions regarding the contents of this report,  
please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

For complaints of state employee misconduct, contact the California State Auditor's  
Whistleblower Hotline: 1.800.952.5665.

December 16, 2014

2014-119

The Governor of California  
President pro Tempore of the Senate  
Speaker of the Assembly  
State Capitol  
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning the disposition of bond proceeds for Community Facilities District No. 2004-3 (Terra Lago).

This report concludes that the city of Indio (city) complied with the requirements of the Mello-Roos Community Facilities Act of 1982 in forming Terra Lago, assigning and paying Terra Lago's development costs, and responding to a tax relief petition from residents. However, the city created inequities between Terra Lago's two improvement areas when it charged \$2.6 million to Terra Lago's Improvement Area Number 1 (Area 1) for water fees that will primarily benefit Improvement Area Number 2 (Area 2), and when it paid \$1.1 million for sewer infrastructure that solely benefits Area 2. As a result, Area 1 property owners are paying higher Mello-Roos special taxes.

The city has recently taken actions that partially addressed the inequities. Specifically, the city finalized an agreement with the new property developer for Area 2, which will pay \$2 million to the city for use in retiring a portion of Area 1 bonds. However, Area 1's bond debt still covers about \$1.2 million of remaining costs that benefit Area 2. Therefore, the city should shift a share of the water facilities cost borne by Area 1 to Area 2 residents in proportion to the benefits Area 2 residents receive from the facilities. To do so, it should impose through its Indio Water Authority a water fee on Area 2 residents and use the related revenues to reduce the bond debt of Area 1.

Respectfully submitted,



ELAINE M. HOWLE, CPA  
State Auditor

Blank page inserted for reproduction purposes only.

## Contents

Summary	1
Introduction	3
<b>Audit Results</b>	
Although the City of Indio Complied With the Mello-Roos Act Community Facilities Act of 1982 and Provided Public Benefit, It Created Inequity Concerning Certain Costs	9
The City Has Taken Steps to Address the Inequity Borne by Area 1 Property Owners, but It Should Do More	14
Recommendation	17
<b>Response to the Audit</b>	
City of Indio	19

Blank page inserted for reproduction purposes only.

## Summary

### Results in Brief

The city of Indio (city) complied with requirements of the Mello-Roos Community Facilities Act of 1982 (Act) in forming Community Facilities District No. 2004-3 (Terra Lago), assigning and paying Terra Lago's development costs, and responding to a tax relief petition from residents. It also constructed facilities as specified in Terra Lago's formation documents. However, it created inequities when it charged Terra Lago's Improvement Area Number 1 (Area 1) \$2.6 million for water fees that will primarily benefit Improvement Area Number 2 (Area 2) and when it paid \$1.1 million for sewer infrastructure that solely benefits Area 2. As a result, Area 1 property owners are paying higher Mello-Roos special taxes. While this created inequity between the two areas, Area 1 and Terra Lago as a whole have benefitted from the constructed facilities.

The city's recent actions related to Terra Lago's Area 1 have partially addressed Area 1 residents' concerns that Area 2 unfairly benefited from bonds supported by Area 1. The city finalized an agreement with the new property developer for Area 2, which will pay \$2 million to the city for use in retiring a portion of Area 1 bonds. This agreement was contingent on the city's elimination of any authority to levy special taxes on Area 2 property owners. While the city has thus taken some steps to reduce the inequities, Area 1's bond debt still covers about \$1.2 million of remaining costs benefitting Area 2. Although the Act may not require it, we believe that the city should require Area 2 property owners to pay for their share of Terra Lago costs.

### Recommendation

The city should shift a share of the water facilities cost borne by Area 1 to Area 2 residents in proportion to the benefits Area 2 residents receive from the facilities. To do so, it should impose through its Indio Water Authority a water fee on Area 2 residents and use the related revenues to reduce the bond debt of Area 1.

### Agency Comments

The city believes its actions have already significantly resolved the inequity between Area 1 and Area 2 and that our recommendation raises procedural and other legal issues that may be difficult to overcome. Nevertheless, it has agreed to further evaluate imposing the water fee that we recommend.

### Audit Highlights . . .

*Our review of the disposition of bond proceeds for Community Facilities District No. 2004-3 (Terra Lago) highlighted the following:*

- » *The city of Indio (city) complied with requirements of the Mello-Roos Community Facilities Act of 1982 (Act) in forming Community Facilities District No. 2004-3 (Terra Lago), assigning and paying Terra Lago's development costs, and responding to a tax relief petition from residents.*
- » *The city created inequities between Terra Lago's two improvement areas.*
  - *It charged Terra Lago's Improvement Area Number 1 (Area 1) \$2.6 million for water fees that will primarily benefit Improvement Area Number 2 (Area 2).*
  - *It paid \$1.1 million for sewer infrastructure that solely benefits Area 2.*
- » *While the city has taken some steps to reduce the inequities, Area 1's bond debt still covers about \$1.2 million of remaining costs benefitting Area 2.*

Blank page inserted for reproduction purposes only.



## Introduction

### Background

Located in Riverside County, the city of Indio (city), with an estimated population of approximately 82,000, provides municipal services under a council-manager form of government. Under this model, a city manager and staff, including a city attorney, serve five elected members of the city council. The five council members are elected at large for four-year terms, and they annually rotate the position of mayor by selecting one of themselves to serve as mayor for the year. The city council is the legislative body of the city and establishes policies, adopts resolutions, holds public hearings, authorizes expenditures, and appoints the city attorney and city manager. The city manager is responsible for administering the city's day-to-day operations.

The Mello-Roos Community Facilities Act of 1982 (Act) allows local governments, including cities, to form what are called *community facilities districts* (districts) to finance property development by issuing a form of property tax-based bonds. The Act provides local governments great flexibility in addressing the individual needs of a district as it is being formed. In forming a district, the governing body, such as the city council of Indio, must first adopt local goals and policies regarding use of the Act. It must also adopt a resolution to establish guidelines for the district regarding its boundaries and planned facilities, as well as policies for issuing the bonds, using the resulting district funds, and levying taxes. A district may be divided into two or more separate sections, known as *improvement areas* (areas).

An individual area or a district as a whole may issue special tax bonds to finance its facilities. If an area or district issues special tax bonds, property owners within that area or district are solely responsible for repaying the incurred debt over time via special taxes levied on their property. This method of financing can be preferable to conventional financing because it offers reduced borrowing costs. Interest paid on special tax bonds is generally excluded from bondholders' taxable income, which allows them to accept a lower interest rate while still achieving the same after-tax return on their investment. This has the effect of reducing costs for developers.

Under state law, sellers must notify the potential buyers of properties in districts about the special tax liability so buyers can make an informed decision about whether to purchase the property and accept the related tax burden. The Act specifies that the special tax notification that potential buyers are to receive includes information on a property's maximum special tax amount and any

planned percentage increases to this tax. The notice is also used to inform potential buyers about where they “may obtain a copy of the district’s resolution of formation that authorized the creation of the community facilities district, and that specifies more precisely how the special tax is apportioned and how the proceeds of the tax will be used . . .”.

#### Examples of Allowable Facilities

- Any real (land or buildings) or other tangible property with an estimated useful life of five years or longer.
- Facilities for utilities such as water, natural gas, telephone, and electrical energy.
- Facilities for flood and storm protection services.
- Parks, recreation areas, parkways, and open-space facilities.
- Libraries.
- Childcare facilities.

Source: Mello-Roos Community Facilities Act of 1982.

The Act allows local governments to use proceeds from district bonds to construct facilities, including infrastructure, that will benefit the area. However, the location of these facilities is not constrained by the district’s geographical boundaries. Facilities can be developed outside of the district. For example, a water facility could be built outside of the physical district boundaries but still serve properties within the district. Facilities such as those in the text box may be financed by district bonds.

#### Community Facilities District 2004-3

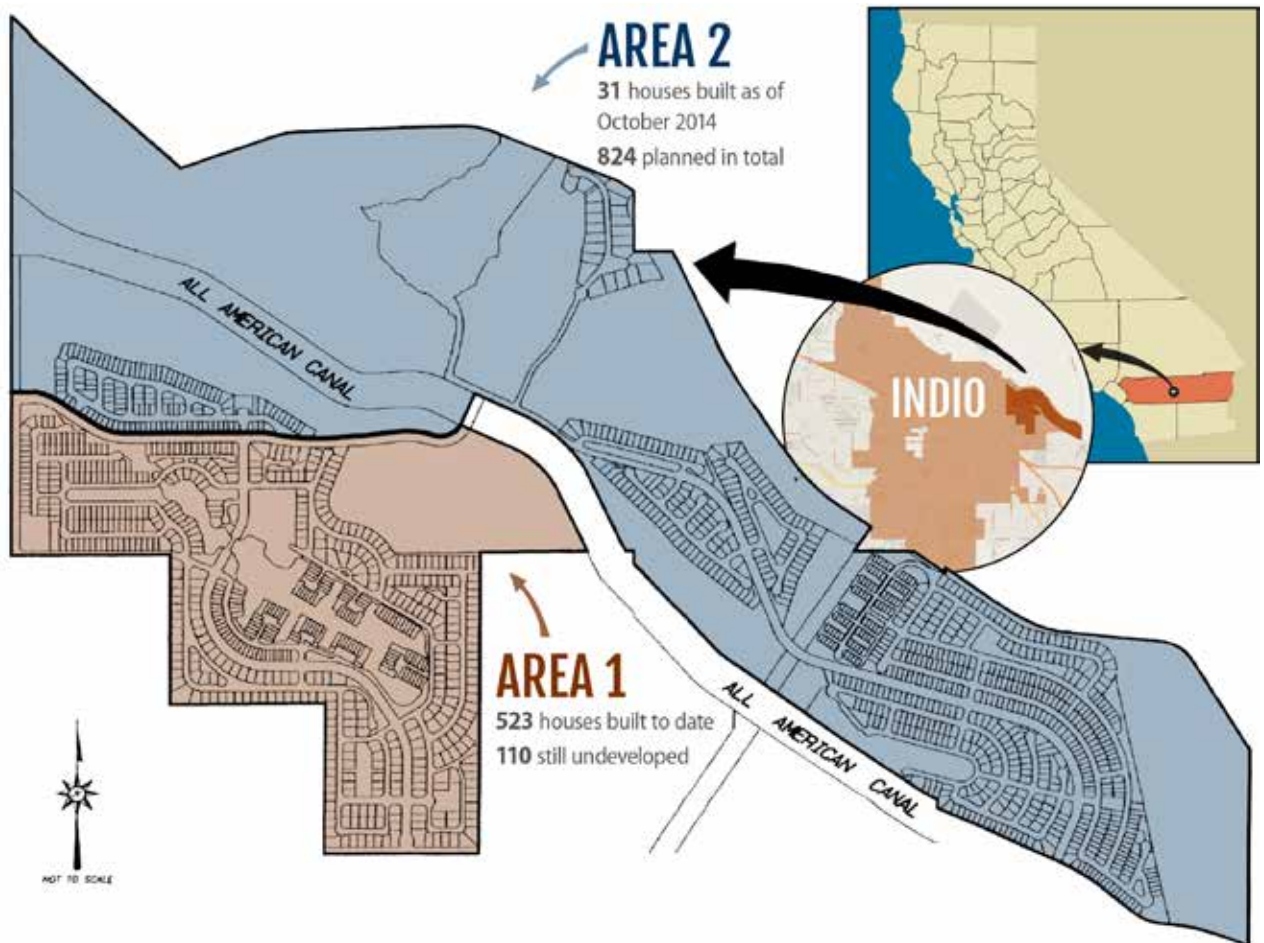
The city formed Community Facilities District No. 2004-3 (Terra Lago) in July 2005, after receiving a written request from a property developer. Terra Lago is located in the northern part of the city and consists of two improvement areas: Improvement Area Number 1 (Area 1) and Improvement Area Number 2 (Area 2).

In September 2005 Area 1 issued \$26.3 million in bonds and deposited \$19.5 million in its acquisition and construction fund, the difference being attributable to \$0.8 million in bond issuance costs and \$1.2 million, \$1.8 million, and \$3 million, respectively, in an interest account, a reserve account, and a special escrow fund. As of September 30, 2014, Area 1 residents had yet to repay \$20.3 million of the bonds. The average annual principal and interest payment on the bonds is about \$1.6 million. Currently, 523 Area 1 property owners are subject to the special tax, which averaged about \$3,000 per property owner in fiscal year 2013–14. According to the city’s finance director, the city regularly monitors the bond market to determine whether any of its bonds can be refinanced and will likely refinance Area 1’s bonds in September 2015. The city estimates the refinancing will produce a savings to Area 1 residents of about \$813,000 valued in today’s dollars.

The city used an acquisition and construction fund to account for Area 1’s bond proceeds held by a fiscal agent. Bond-related agreements require the city to approve and appropriately document requests for disbursements of this money. The city requested

disbursement of a portion of the bond proceeds, as allocated in the bond documents, to pay for city fees (such as the water system, fire, police, storm drains, and parks) and other fees (such as school and sewer) normally charged to new property developments. These fees help offset the increased demand that new property developments place on the city's ability to provide public facilities. Bond proceeds also reimbursed the property developer for certain construction costs, including street improvement, sewer, landscaping, site preparation, and engineering costs. Payment of the fees and all sizable reimbursements to the property developer concluded in August 2008.

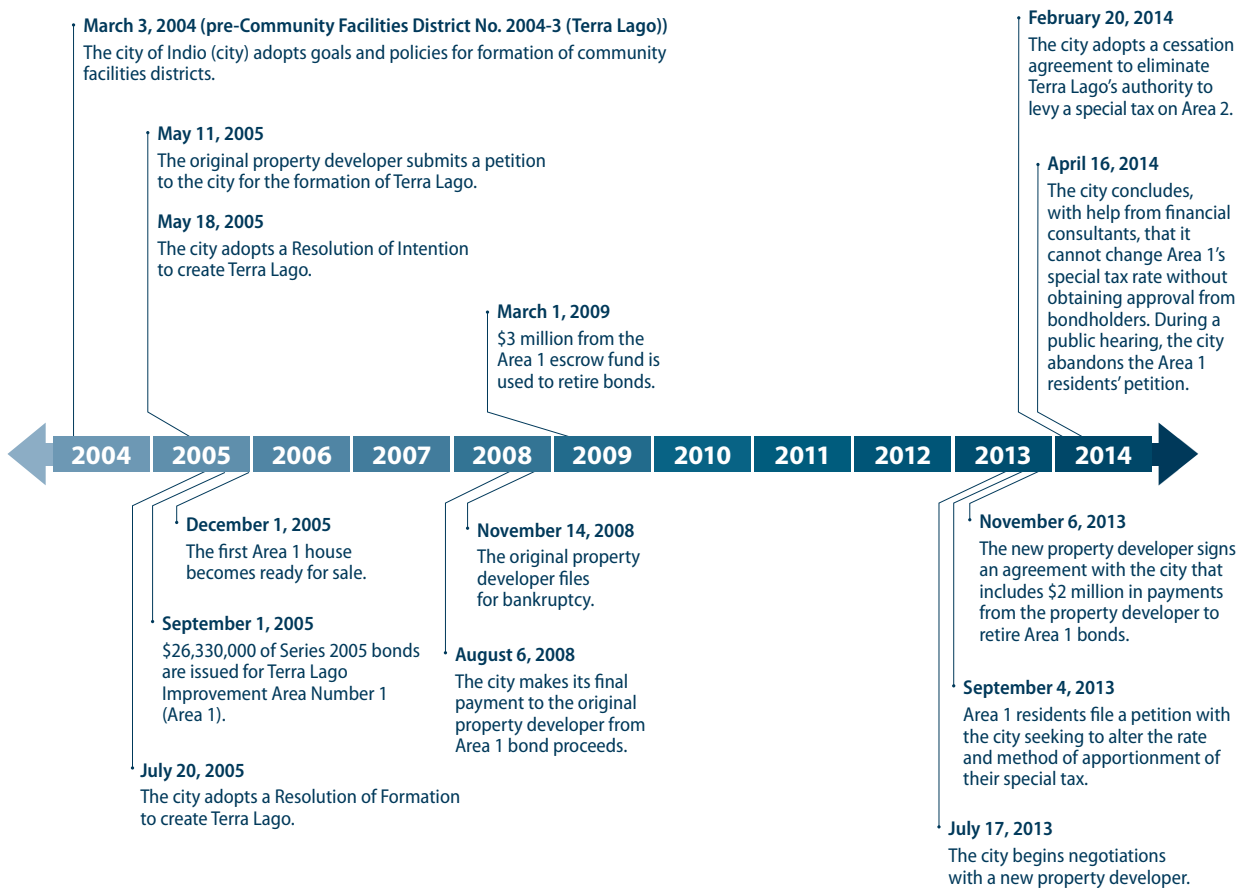
**Figure 1**  
Community Facilities District No. 2004-3 Improvement Areas



Sources: City of Indio (city) council meeting minutes, Community Facilities District No. 2004-3 agreement of formation, and interviews with the city's development services director and city attorney.

In fiscal year 2006–07, residents started moving into Area 1 and paying special taxes. However, Terra Lago’s property developer from 2005 through 2008 (original developer) went bankrupt when the housing market took a sharp decline in 2008, leaving a small portion of Area 1 and all of Area 2 unfinished. For about five years, development of Terra Lago was halted, but in 2013 a new property developer approached the city about making changes to the number of previously planned Area 2 units before beginning development. As of October 2014 the developer has built 31 units in Area 2. According to the city, construction of Area 1’s remaining 110 undeveloped lots has not started because no property developer has expressed a willingness to do so; for now, those lots remain vacant. Since the time of Terra Lago’s formation, the city has formed two additional community facilities districts. Figure 2 shows a timeline of Terra Lago events.

**Figure 2**  
**Community Facilities District No. 2004-3 Timeline of Events**



Sources: California State Auditor’s analysis of Terra Lago resolutions, Indio city council meeting minutes, Terra Lago financial records, and city agreements with Terra Lago developers.

## Scope and Methodology

The Joint Legislative Audit Committee (audit committee) directed the California State Auditor to perform an audit of the city's Acquisition and Construction Fund and of the use of proceeds from its Series 2005 Special Tax Bonds. Table 1 outlines the audit committee's objectives and our methods for addressing them.

**Table 1**  
**Audit Objectives and the Methods Used to Address Them**

AUDIT OBJECTIVE	METHOD
1 Review and evaluate the laws, rules, and regulations significant to the audit objectives.	We identified, reviewed, and evaluated relevant laws, rules, and regulations.
2 Review the formation and disclosure documents related to Community Facilities District No. 2004-3 (Terra Lago) and actions taken by the city of Indio (city) to address the concerns of Terra Lago special taxpayers to determine compliance with the Mello-Roos Community Facilities Act of 1982 (Act).	<ul style="list-style-type: none"> <li>• To test for compliance with the Act's formation and disclosure requirements, we reviewed city council meeting minutes and resolutions, and other district formation and disclosure-related documents.</li> <li>• To test for compliance with the Act's petition requirements, we reviewed the city's documentation regarding how it processed and reacted to the Terra Lago Improvement Area Number 1 (Area 1) residents' petition for a special tax adjustment.</li> </ul>
3 Review the Acquisition and Construction Fund expenditures to determine compliance with the Act and whether the city appropriately identified costs related to Terra Lago Improvement Area Number 2 (Area 2).	<p>To determine whether district expenditures complied with the Act, were appropriately identified as relating to Area 1, and were reasonably supported, we selected significant expenditures and performed the following tests:</p> <ul style="list-style-type: none"> <li>• Obtained and reviewed documents supporting expenditures, such as reimbursement requests, city agreements, progress billing reports, and invoices.</li> <li>• Compared expenditure amounts with budgeted amounts.</li> <li>• Compared city fees and other fees paid by Area 1 to schedules of capital improvement fees in effect at the time.</li> <li>• Determined whether the costs of facilities were allocated equitably to Area 1 based on the benefits received by Area 1 or Area 2.</li> <li>• Identified the amount of money spent by Area 1 on facilities and services that benefit Area 2, reduced by the amount to be paid back to Area 1 per the city's agreement with Area 2's current property developer.</li> </ul>
4 Review recent actions taken by the city related to funding provided by Area 1 and Area 2 to determine whether these actions result in a reduction of the debt incurred by Terra Lago that provided the capital improvements in order to reduce the special tax payments of the taxpayers in Area 1.	<ul style="list-style-type: none"> <li>• We reviewed the agreement between the city and Area 2's current property developer.</li> <li>• We estimated the amount of principal to be reduced as a result of the agreement.</li> </ul>

Sources: California State Auditor's analysis of Joint Legislative Audit Committee audit request 2014-119, and information and documentation identified in the table column titled *Method*.

Blank page inserted for reproduction purposes only.

## Audit Results

### **Although the City of Indio Complied With the Mello-Roos Community Facilities Act of 1982 and Provided Public Benefit, It Created Inequity Concerning Certain Costs**

The city of Indio (city) complied with requirements of the Mello-Roos Community Facilities Act of 1982 (Act) in forming Community Facilities District No. 2004-3 (Terra Lago), assigning and paying Terra Lago's development costs, and responding to a tax relief petition from residents. Additionally, our review determined that Terra Lago's original property developer constructed only facilities covered by Terra Lago's formation documents. However, our review of Terra Lago's expenditures identified nearly \$3.7 million of water fees and sewer infrastructure costs paid for with bond proceeds from its Improvement Area Number 1 (Area 1) that will primarily or solely benefit the district's Improvement Area Number 2 (Area 2). These expenditures violated a policy in Terra Lago's formation document that says special taxes will be based on the direct or indirect benefit each property will receive from district facilities. While this created inequity between the two areas, Area 1 and Terra Lago as a whole have benefitted from the facilities constructed.

#### ***The City Met Act Requirements***

In forming Terra Lago, in assigning and paying the district's development costs, and in responding to a petition from residents requesting a tax rate reduction, the city met the requirements of the Act. The Act requires that general goals and policies regarding the priority of facilities to be financed and the apportionment of special taxes be in place for community facilities districts (districts) before such districts are formed. The city met this requirement before initiating proceedings to form Terra Lago. The city's goals and policies say that priority will first be given for financing public facilities, such as water mains, sewer mains, and electrical conduits, including related connection or development impact fees. They also state that the rate and method of a district's special tax apportionment must be both reasonable and equitable in apportioning the costs of financed public facilities to each property within the district, and that the city prefers that the apportionment of costs be based on the benefit that each property receives. The city also followed the Act's district formation requirements, thereby setting up Terra Lago appropriately. For example, Terra Lago's formation resolution identified a broad range of facilities to be funded with the special tax, including water and sewer facilities, roadways, storm drain and landscape improvements, traffic control devices, and a fire station. This resolution also made the city's

preference for apportionment of costs based on benefits received a requirement for Terra Lago. Terra Lago's formation resolution says that special taxes will be based on the cost of financing facilities in the district, the demand that each property will place on the facilities, and the direct or indirect benefit each property will receive from the facilities.

The Act is fairly broad regarding the financing and payment of a district's development costs. We reviewed costs paid with Area 1 bond proceeds and found that Terra Lago's property developer from 2005 through 2008 (original developer) requested payment only for the types of constructed facilities and ancillary costs that were included in the district's formation documents. In reimbursing the developer \$5.2 million for these costs, the city complied with the Act. The city also complied with the Act when it assigned and paid development fees of \$13.8 million with Area 1 funds. In the first four years of development, the city used the majority of Area 1's bond proceeds, 86 percent, to pay for construction-related costs and for fees. As of June 30, 2014, it had spent about 94 percent of bond proceeds, as shown in Table 2. While the developer's actual costs exceeded budgeted amounts for a few cost categories, overall actual costs came in under budget.

**Table 2**  
Comparison of Budgeted Costs to Actual Costs Financed by Improvement Area Number 1's Bonds as of June 30, 2014  
(In Thousands)

COST CATEGORY	BUDGETED	ACTUAL	DIFFERENCE BETWEEN BUDGETED AND ACTUAL
<b>City Fees</b>			
Storm drainage fees	\$88	\$88	–
Fire Station mitigation fee	1,000	1,000	–
Sheriff/Police fee	54	54	–
Public buildings fee	255	255	–
Bridge/major street impact fees	445	445	–
Transportation uniform mitigation fee	505	505	–
Water capital improvement fees	4,489	4,489	–
Park capital impact fee	1,264	1,264	–
<b>Subtotals—city fees</b>	<b>\$8,100</b>	<b>\$8,100</b>	<b>–</b>
<b>Other Fees</b>			
School fees	\$5,597	\$3,758	\$1,839
Sewer connection capacity fees	1,978	1,978	–
<b>Subtotals—other fees</b>	<b>\$7,575</b>	<b>\$5,736</b>	<b>\$1,839</b>
<b>Subtotals—city and other fees</b>	<b>\$15,675</b>	<b>\$13,836</b>	<b>\$1,839</b>



COST CATEGORY	BUDGETED	ACTUAL	DIFFERENCE BETWEEN BUDGETED AND ACTUAL
<b>Capital Costs Reimbursable to Developer</b>			
Site preparation	\$355	\$95	\$260
Surface improvements	592	2,505	(1,913)
Landscaping	1,509	278	1,231
Traffic control	610	–	610
Water	1,186	–	1,186
Sewer	814	1,097	(283)
Engineering	2,014	528	1,486
Dry utilities	263	508	(245)
Contingency	504	58	446
Other miscellaneous capital costs	379	83	296
<b>Subtotals—capital costs reimbursable to developer</b>	<b>\$8,226</b>	<b>\$5,152</b>	<b>\$3,074</b>
Shortfall—to be reimbursed to developer from Phase 2*	(1,404)	–	–
<b>Subtotals—developer reimbursement</b>	<b>\$6,822</b>	<b>\$5,152</b>	<b>\$1,670</b>
<b>Other Bond Disbursements</b>			
Capitalized interest	\$1,234	\$1,234	–
Costs of issuance	335	335	–
Underwriter's discount	435	435	–
Retirement of bonds†	–	3,000	(\$3,000)
Other costs	–	602	(602)
<b>Subtotals—other disbursements</b>	<b>\$2,004</b>	<b>\$5,606</b>	<b>(\$3,602)</b>
<b>Total Costs</b>	<b>\$24,501</b>	<b>\$24,594</b>	<b>(\$93)</b>
Dividends and other credits	–	(\$726)	\$ 726
Reserve account	\$1,758	1,758	–
<b>Grand Totals</b>	<b>\$26,259‡</b>	<b>\$25,626</b>	<b>\$633§</b>
Total actual costs as a percentage of bond proceeds (\$24,594 / \$26,259)			93.7%

Sources: Revised bond proceeds budget as of September 8, 2005, the city of Indio's (city) reconciliation of bond proceeds, and other city financial documents.

\* This shortfall stems from \$8.2 million in budgeted costs but only \$6.8 million available in remaining Phase 1 bond proceeds. The city anticipated that when Phase 2 bonds were issued, \$1.4 million would reimburse the developer for its budgeted costs.

† According to provisions in the official statement for Improvement Area Number 1 (Area 1) bonds, \$3 million was set aside in a special escrow fund for later use if the developer met certain financial conditions. These conditions were not met, and the amount was used to retire bonds subsequent to 2007.

‡ The budgeted column grand total of \$26.3 million is the total amount of proceeds Area 1 obtained from its bond issuance.

§ This residual amount is held in the city's Acquisition and Construction Fund for Community Facilities District No. 2004-3.

*After holding a public hearing on the matter, the city council voted in April 2014 to abandon proceedings to modify the special tax.*

Further, the city followed requirements in the Act for responding to a petition that Area 1 residents issued in September 2013. The petition requested that special tax rates be modified so that undeveloped property in Area 1 would also pay the tax and that Area 2 would pay an amount to compensate Area 1 going forward. The city approved a resolution to consider the change, drafted a proposed amendment, and conducted a public hearing on the matter. The city also hired two financial consulting firms to determine the viability of amending the tax. Based on the consultants' conclusions, the city determined that it could not modify Area 1 tax rates without gaining bondholder consent because doing so would prevent Terra Lago from adhering to agreements with bondholders. The report to the city council noted that the consent of the owners of a majority of bonds is typically viewed as difficult to obtain. It cited a low response rate as a significant factor in the challenge of obtaining majority consent and also said that bondholders might see the change in special taxes with respect to undeveloped property as taking on more risk with regard to their investment. After holding a public hearing on the matter, the city council voted in April 2014 to abandon proceedings to modify the special tax. Further, the city determined that the Act prohibits it from considering requests made by Area 1 that affect any improvement area other than Area 1. Thus, it did not pursue the petition's request to have Area 2 make payments to compensate Area 1.

***The City Created Inequity by Using Area 1 Bond Proceeds for Infrastructure That Will Primarily or Solely Benefit Area 2, but It Has Taken Steps to Reduce the Inequity***

The city spent about \$3.7 million of Area 1's bond proceeds on water and sewer infrastructure that will primarily or solely benefit Area 2. The water infrastructure was financed by a water capital improvement fee (water fee) that Area 1 paid directly from bond proceeds; the sewer infrastructure built in Area 2 was financed by the original property developer, who then received reimbursement from Area 1's bond proceeds.

When the district's development was planned, city staff believes the city determined that the existing water infrastructure system was inadequate to serve a populated northeastern corner of the city as well as all of the planned Terra Lago Project Master Plan development, which was approximately 765 acres. The city's current finance director, who did not work for the city at the time, said he believes that at the time of planning for Terra Lago, the city needed to build water infrastructure that would ensure proper fire hydrant pressure to all planned homes and business developments in the area. He surmised that it was logical to presume that the

city needed to construct backbone water infrastructure to provide services to north Indio, including areas 1 and 2, to ensure the health and welfare of such areas, and that water fees received for both areas 1 and 2 were needed to ensure that enough funds were collected to construct such improvements. He reasoned that since the city was growing rapidly at that time, particularly in north Indio, it was logical to presume that the city needed to construct sufficient water backbone infrastructure that could serve all of Terra Lago, as well as other planned developments in the area, rather than construct two separate, smaller water systems for each individual improvement area. This approach seems reasonable. Nevertheless, its implementation ran counter to the district's formation document, which states that special taxes will be based on the demand each property will place on, and the benefit each property will receive from, financed facilities, and was thus inequitable to Area 1 property owners. The city calculated Area 1's total water fee by multiplying its standard water fee of \$3,025 per housing unit by 1,484 housing units, the total number of planned units for all of Terra Lago. Thus, rather than using only Area 1's 636 planned units, as it had done for other fee calculations, the city included Area 2's 848 planned units as well.<sup>1</sup> As a result, the city spent about \$4.5 million of Area 1 bond proceeds on water fees—roughly \$2.6 million of which was applicable to Area 2—without devising an adequate way to compensate Area 1 for these fees.

The city's agreement with the original property developer states that the developer was to pay the entire water fee from Area 1's bond proceeds and that the developer would be reimbursed for the prepayment, without interest, from proceeds of Area 2's bonds, once issued. Although the current city attorney did not work on the transaction, she said that a possible explanation for the plan to reimburse the developer is that the developer had reimbursable costs that, when combined with development fees, exceeded Area 1's bond proceeds. Thus, by including Area 2's water fee in the amount to be paid from the bond proceeds, the developer gave up other amounts for which it could have requested reimbursement. However, we do not understand why the developer was named as the recipient of the reimbursement, since it was Area 1 bond proceeds, not the developer, that actually paid the water fee. Area 2 has never issued bonds and thus has never made such a reimbursement to the developer or to Area 1, although Area 2 has access to and benefits from the water system. Despite lacking an adequate plan to address this inequity relating to Area 1, the city partially addressed the problem through an agreement with Area 2's new developer, as discussed in the next section.

*The city spent about \$4.5 million of Area 1 bond proceeds on water fees—roughly \$2.6 million of which was applicable to Area 2—without devising an adequate way to compensate Area 1 for these fees.*

<sup>1</sup> The original developer later opted to reduce the number of Area 1 units from the 636 originally planned to 633. The new developer opted to reduce the number of Area 2 units from the 848 originally planned to 824.

In addition, the city used \$1.1 million of Area 1 bond proceeds to reimburse the original property developer for sewer infrastructure constructed within Area 2. This was unjustified because the sewer infrastructure in Area 2 would never benefit Area 1, and thus this payment did not conform to the district policy of basing an area's special taxes on the benefits received from the related facilities. The city had a process in place to review facilities eligible for reimbursement from Area 1 proceeds. Nevertheless, it paid the reimbursement for Area 2 sewer facilities. The city has admitted that it erred in this regard. Fortunately, in 2013, the city took action to resolve the inequity related to the sewer infrastructure, as discussed in the next section.

### **The City Has Taken Steps to Address the Inequity Borne by Area 1 Property Owners, but It Should Do More**

***Although the city recently agreed to reduce Area 1 bond debt by about \$2 million, we estimate that about \$1.2 million remains that Area 2 should pay.***

Residents of Area 1 have raised concerns that their special taxes are unfairly high as a result of costs paid with Area 1 bond proceeds for infrastructure that benefits residents of Area 2. The city recently took actions to partially address these concerns by agreeing to reduce Area 1 bond debt by about \$2 million. Though this was a positive step toward providing equity for Area 1, we estimate that about \$1.2 million remains that Area 2 should pay. As noted in the previous section, the city created this inequity by apportioning costs in a manner that was inconsistent with its plan for Terra Lago, as stated in the district's formation documents. It currently has no mechanism in place to address the remaining inequity.

In November 2013 the city finalized an agreement with the new property developer that will develop Terra Lago's Area 2. According to the agreement, the developer will pay \$2 million to the city as agent for Area 1, and in exchange the city will use these funds to retire Area 1 bonds. The agreement also stated that if the authority to levy taxes on Area 2 was not eliminated, the agreement would be voided, meaning that if the city council declined to approve the developer's request for cessation of the special tax, the developer would no longer be obligated to pay the \$2 million. The amount the new developer will pay is divided into two parts. The first part is a one-time payment of about \$1.1 million, which the city will use to retire a portion of Area 1 bonds before their maturity date, a process known as *calling bonds*. This action will occur no earlier than September 1, 2015, the earliest allowable call date. According to the finance director, this amount is intended to compensate Area 1 for the cost of the sewer infrastructure built in Area 2 and paid for with Area 1 bond proceeds.

The second part is a series of ongoing payments that the new developer will make as it constructs residences in Area 2: \$1,040 for each of the 824 units the developer plans to complete. The city received \$32,240 from the developer in October 2014 related to the 31 units completed so far. The total payment of roughly \$857,000 will be made over the course of between six and nine years, the city's estimated time period for completion of all Area 2 units. This amount exactly equals the park dedication fees, also known as Quimby fees, that the developer would normally have had to pay to the city. In this case, the city gave the developer a credit against the park fees pursuant to its authority under the city's municipal code and agreed to use the ongoing payments to retire more Area 1 bonds.

The September 2015 bond retirement, and possibly the future retirements, will be subject to a charge known as a *premium*. This premium will cost \$22,400 for the lump-sum retirement and, depending on when the bonds are called with the funds from the ongoing payments, could cost up to about \$4,500 more. Taking these premium costs into account, we estimate that the combined payment of \$2 million from the new developer will reduce Area 1's bond principal by about \$1,975,000, or 9.7 percent of the bonds currently outstanding. This, however, still leaves an unaddressed inequity for Area 1 of about \$1.2 million.

The calculation for the remaining inequity, as seen in Table 3 on the following page, is based in part on several assumptions. The water facilities cost attributable to Area 2 is about \$2.6 million, which is a product of the water fee rate and the originally planned number of Area 2 units. Financial statements from the Indio Water Authority, the entity owning these water facilities, list the useful life for its utility distribution system as 70 years. Additionally, because few units in Area 2 have been built so far, the water system is largely not yet benefitting Area 2. Based on the city's expectation for the construction of Area 2, Area 2 may not begin receiving significant benefits from the water system for five more years, when most of Area 2's units are built. Area 1, on the other hand, has already been using the water system and thus receiving its benefits for about nine years. For this reason, we deducted 14 years from the useful life of 70 years and attributed only 56 of the facilities' 70 years of benefit to Area 2. When we applied Area 2's proportion of benefits to the original cost, the total amount attributable to Area 2 fell to about \$2.1 million. Reduced by the ongoing payments previously mentioned, the remaining inequity amounts to about \$1.2 million. This translates into an inequity of roughly \$2,300 borne by each developed unit in Area 1 and a cost of about \$1,500 for each planned unit in Area 2 to resolve the inequity.

**Table 3**  
**Estimate of Remaining Water Fee Inequity**  
**Community Facilities District No. 2004-3**

Portion of Community Facilities District No. 2004-3 (Terra Lago) water capital improvement fee (water fee) related to Improvement Area Number 2 (Area 2) planned units	\$2,565,412
Average estimated life of water distribution infrastructure	70 years
Area 2 estimated years of water system benefit	56 years
Adjusted Area 2 portion of water fee (\$2,565,412 x 56/70)	\$2,052,330
Total ongoing payments to be made by Area 2 developer	(\$856,811)
Remaining water fee inequity	\$1,195,519

INEQUITY COST PER IMPROVEMENT AREA NUMBER 1 (AREA 1) AND AREA 2 UNIT

AREA 1		AREA 2	
Number of developed properties in Area 1	523	Number of planned properties in Area 2	824
Water system inequity per Area 1 developed unit	\$2,286	Cost to each Area 2 planned unit to resolve remaining inequity	\$1,451

Sources: California State Auditor's analysis of the official statement for Terra Lago's bonds, Indio Water Authority financial statements, the city of Indio's 2013 agreement with Terra Lago's new property developer, and interviews with city officials.

To resolve the remaining cost inequity, we believe the city should require Area 2 property owners to pay for their share of the water system. The city believes that it is not obligated to do anything more because the Act is broad regarding how the costs of a district's facilities may be apportioned. Nevertheless, the city's resolution of formation for Terra Lago includes a policy on special tax levies stating that Terra Lago's special tax is based upon the cost of financing the facilities in the district, the demand that each unit will place on the facilities, and the benefit (direct and/or indirect) received by each unit from the facilities. Based on this, we believe Area 1 should have to pay for only the water system costs benefitting its units. Thus, to comply with its own policy, the city should resolve the water system inequity.

To achieve equity for Area 1 property owners, we believe the city, through its Indio Water Authority, should impose a water fee on Area 2 residents in proportion to the benefit they receive from the water system and should use the related revenue to reduce Area 1 bond debt. According to the city attorney, such a fee would be unlawful because it would not represent the proportional cost of providing water service to Area 2. Considering that the water system cost has already been paid by Area 1, the city attorney believes there are no water impacts left to be mitigated and that retroactively reducing the special tax imposed on Area 1 would actually be a prohibited gift of public funds. Our legal counsel disagrees and states that water service fees that do not exceed the proportional cost of providing the service are permissible under the California constitution. We believe the intent of the fee would be to recover the proportionate cost of the water system that is attributable to Area 2,

and that equalization of the tax burden borne by the taxpayers in Area 1 would be a positive by-product. The fee should be calculated to fairly apportion the costs of the water system across the entire district. Further, Area 1 bonds used to pay for the water system are still outstanding, so the new fee would merely redistribute the cost of financing the water system more equitably between Area 1 and Area 2. We estimate the total water fee applied to Area 2 property owners should raise roughly \$1.2 million. The fee should be enacted once Area 2 is substantially built, residents have moved in, and the area is receiving significant benefit from the water system. Before the city imposes the fee, however, it should perform a calculation similar to the California State Auditor's calculation using more precise and up-to-date information so it can ensure that the amount it seeks to collect will be as accurate and fair as possible.

### Recommendation

The city should shift a share of the water facilities cost borne by Area 1 to Area 2 residents in proportion to the benefits Area 2 residents receive from the facilities. To do so, it should impose through its Indio Water Authority a water fee on Area 2 residents and use the related revenues to reduce the bond debt of Area 1.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the scope section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,



ELAINE M. HOWLE, CPA  
State Auditor

Date: December 16, 2014

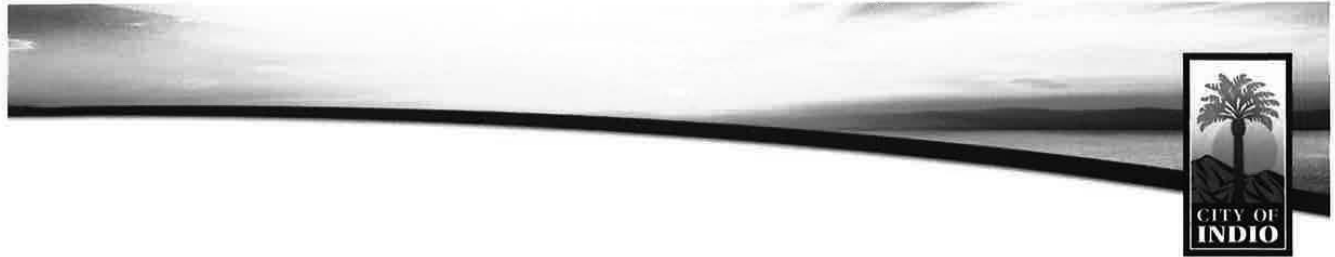
Staff: Jim Sandberg-Larsen, CPA, CPFO, Audit Principal  
Dan Motta, CPA  
Martin T. Lee, CPA  
Veronica Kaufman

Legal Counsel: Scott A. Baxter, JD, Sr. Staff Counsel

For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

Blank page inserted for reproduction purposes only.





November 21, 2014

Ms. Elaine M. Howle  
State Auditor  
Bureau of State Audits  
555 Capital Mall, Suite 300  
Sacramento, California 95814

Dear Ms. Howle:

On behalf of the City of Indio ("City"), I am in receipt of the draft report prepared by the Bureau of State Audits ("BSA") concerning City of Indio Community Facilities District No. 2004-3 (Terra Lago) ("Terra Lago CFD"). Thank you for the opportunity to comment on the report titled "City of Indio: Although the City Complied with the Mello-Roos Act in Forming and Managing Community Facilities District 2004-3, It Should Do More to Address Inequities" ("Audit Report").

First and foremost, the City appreciates the diligent work of the BSA to review transactions that commenced ten years ago involving City staff no longer employed with the City. Second, the City is pleased that the BSA concluded that the City complied with the requirements of the Mello-Roos Act of 1982 ("Act") with respect to: (i) its formation; (ii) assigning and paying and reimbursing expenditures from Terra Lago CFD bond proceeds; and (iii) responding to a recent residents' petition for tax relief. This is an important finding not only for the City but for the community.

As the BSA is aware, claims have been made by a small vocal group of residents and/or property owners that live within Area 1 of the Terra Lago CFD regarding the formation of the Terra Lago CFD, expenditure of bond proceeds and a general belief that their tax burden is too high. These claims were made notwithstanding the fact that Area 1 homeowners voluntarily purchased their property in Area 1 knowing they purchased property in a Mello Roos District and for many of them at the height of the market.

Notwithstanding, when these claims were brought to the City's attention in the spring/summer of 2013, the City's new leadership team (that had no involvement with the formation or disbursement of funds from the Terra Lago CFD) directed staff to conduct its own internal review of the Terra Lago CFD expenditures. From this, the City determined that bond proceeds were reimbursed to the developer for sewers installed in Area 2. The City has been forthright regarding this expenditure from the beginning and it appreciates that the BSA recognized the City's efforts in resolving this error.



The City also determined that the payment of water impact fees for both Area 1 and Area 2 were legally permissible under the Act. Such fees are collected from all developers of property and are used to construct large public improvements as was done for the Terra Lago community. Also, the City's use of the bond proceeds was reasonable and legal under the Act. While the City understands that Area 1 homeowners believe this was unfair, Area 1 homeowners benefitted and continue to benefit from the construction of needed water capital improvements in an area that encompassed hundreds of acres of vast vacant desert land. The City appreciates that the BSA concluded that Area 1 homeowners have been receiving the benefits of such a water system for at least 9 years.

While the work of the BSA team was extremely comprehensive and thorough, it was not a surprise to the City that ultimately the Audit Report focused on these two areas and concluded that while the City/District complied with the law, the expenditures made by the District created an inequity for Area 1. Accordingly, the BSA's position is based on equity driven by the facts in this matter.

While the City understands the results of the BSA's findings and its basis for such findings (i.e. noncompliance with goals and policies), the City has been steadfast in its position that the payment of the water impact fees was an appropriate and legal expenditure of funds, and the City has already significantly resolved the inequity by entering into an agreement with the new developer of the property in Area 2 to reduce the bond debt in Area 1 by \$2 million dollars. In fact, the BSA correctly notes that through such action, the City has already (partially in the view of BSA) addressed the inequity. Notwithstanding, the BSA believes that the City "should do more."

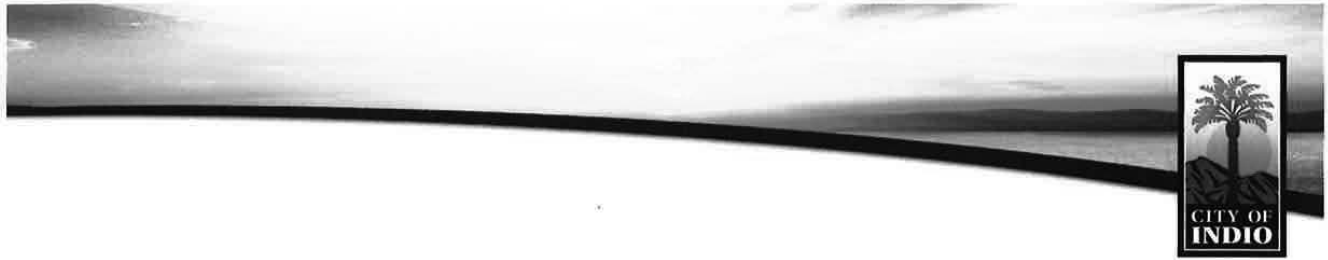
Accordingly, with that background in mind the City addresses the recommendation contained in the Audit Report as follows:

**Recommendation:**

*"The City should shift a share of the water facilities borne by Area 1 to Area 2 residents in proportion to the benefits Area 2 residents receive from the facilities. To do so, it should impose through its Indio Water Authority a water fee on Area 2 residents and use the related revenues to reduce the bond debt of Area 1."*

**City Response:**

Having heard from our residents regarding this issue, the City took proactive steps to address their concerns even though the City was not legally required to do so. The City did so because it too desired to address the equitable nature of the situation as raised by its residents. The City continues to assert that the recommendation raises procedural and other legal issues that may be difficult to overcome. The Audit Report



succinctly captures the City's legal position on the recommendation, which the City continues to reiterate and need not restate here.

That said, the BSA has provided a timeline for implementation of the recommendation, which is when Area 2 is substantially built, residents have moved in, and the area is receiving significant benefit from the water system. Notwithstanding the City's concerns, the City agrees to further evaluate whether constitutionally such a fee may be imposed in addition to evaluating the legal risks for imposing such a fee regardless of the constitutional concerns at the time the BSA recommends implementation.

In closing, the City would like to recognize and personally thank each member of the audit team for their professionalism in conducting this audit. Should you require additional information, do not hesitate to contact me.

Sincerely,

  
Dan Martinez  
City Manager