

May 22, 1995

95107

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

Dear Governor and Legislative Leaders:

The Joint Legislative Audit Committee requested that we review the status of Orange County's (county) financial restructuring plan (plan). The leadership of Orange County has worked with a number of private and public entities to develop a financial restructuring plan. This plan includes a variety of revenue generating activities that the county plans to use to repay the \$1.69 billion loss in the investment pool and to avoid default on the county's short-term debt while enabling the county to continue providing essential services to the public. Major components of the plan involve issuing approximately \$1.4 billion of bonds and generating new general fund revenues. Implementation of these components required legislation that was approved on May 12, 1995, and became effective immediately. However, the county's ability to fully implement the plan is dependent upon many factors including the accuracy of the revenue estimates, the voters' approval of the half-cent sales tax, and the court's approval of the county's plan. Without the sales tax increase, the county's plan as currently structured will not succeed.

BACKGROUND

As we reported in March 1995, the former treasurer of the county engaged in risky and imprudent investments which resulted in losses of \$1.69 billion and caused the county to file for bankruptcy protection in December 1994. Since that time, the county has developed a six-step plan that attempts to provide solutions for the county's financial crisis. The first step which included the liquidation and reinvestment of the county's investment portfolio in more appropriate short-term investments is complete. The second step requires the county to reduce its general fund budget by 40 percent.

Steps three and four of the plan focus on satisfying the needs of the investment pool participants by prioritizing their claims, distributing the remaining investment pool assets, and issuing Recovery Notes to provide additional funding to compensate for the losses incurred by non-county public entities. As a result of negotiations between the county and non-county representatives, the county's legal advisors filed a settlement agreement (settlement) with the bankruptcy court (court). The court approved the settlement on May 2, 1995. The settlement allows the county to distribute to the pool participants the assets that are available as a result of the liquidation of the county's investments. This results in the pool participants receiving an average of approximately \$.77 on each \$1.00 invested in the pool at the date of the bankruptcy. The county scheduled this distribution for May 19, 1995. Additionally, the settlement includes the options available to the pool participants to recover the remaining approximately \$.23 on each \$1.00 invested in the pool, and it authorizes the county to issue Recovery Notes in payment of some of this debt.

Finally, the fifth and sixth steps of the plan involve the development of a financing plan that will address the county's short-term debt that comes due between June and August 1995, and the county and non-county investment losses. In total, the county estimates that to repay 100 percent of the investment pool losses, its short-term debt, and other claims, it must identify new funding sources totaling approximately \$2.0 billion. In the following section of this letter, we discuss the key elements of the restructuring plan.

FINANCIAL RESTRUCTURING PLAN

The primary objectives of the financial restructuring plan (plan) are to raise capital to assist the county in meeting its short-term and long-term obligations and its ongoing operating needs and to return the invested principal to the pool participants. Step two of the plan requires that the county develop a balanced general fund budget for fiscal year 1995-96. Because the county is in the preliminary stages of developing this budget and in making the necessary cuts, we are unable to assess this portion of the plan. The plan is comprised of five main components to raise the funds necessary to repay its \$2.0 billion debt. Three of these components will be implemented regardless of the half-cent increase in sales tax. However, two essential components are dependent upon the passage of a half-cent sales tax on June 27, 1995. In the following three sections, we describe the three components of the plan that do not rely on an increase in the sales tax.

- ***Recovery Notes***

Step four of the plan calls for the issuance of Recovery Notes. In accordance with the settlement approved by the bankruptcy court on May 2, 1995, the county planned to issue Recovery Notes to net the county approximately \$236 million after costs of issuance and deposits to the debt service reserve. As of May 19, 1995, the county plans to issue Certificates of Participation (COPs) instead of notes. These COPs will be secured by a pledge of certain Motor Vehicle License Fees. The county has underwriters for the COPs and plans to issue the COPs in June 1995. The settlement requires that the county distribute the proceeds to school districts and non-school entities in amounts that equate to approximately \$.13 and \$.03, respectively, on each \$1.00 of their original investment losses.

- ***Restructuring of the Teeter Program***

In 1949, the California Legislature established an alternate method for the distribution of secured property taxes to local agencies. This method, known as the Teeter program, was adopted by the county's Board of Supervisors on June 29, 1993. Under the Teeter program, the county issued short-term notes and used the proceeds to distribute to agencies located in the county the full amount of their share of the property taxes, including property tax delinquencies that have yet to be collected. Generally, the Teeter program provides for a tax distribution procedure in which secured roll property taxes are distributed to taxing agencies within the county included in the Teeter program on the basis of the tax levy, rather than on the basis of actual tax collections. Thus, the Teeter program provides participating local agencies with a stable cash flow and eliminates collection risk. In return, the county receives all future delinquent tax payments, penalties, and related interest which are used to repay the notes as they become due.

In July and August of 1994, the county issued Teeter notes totaling approximately \$175 million. These notes are due and payable on June 30, 1995. However, as a result of the bankruptcy, the county does not have sufficient reserves set aside to repay these notes. Thus, it developed this component of the restructuring plan.

The plan proposes restructuring the Teeter program as a self-sustaining entity. On May 12, 1995, the governor approved SBX2-7 which will allow the county to establish the Teeter program as a self-sustaining program. Specifically, SBX2-7 authorizes the county, with the approval of four-fifths of the county supervisors, to create a joint powers agency (JPA) for the purpose of issuing bonds. Further, SBX2-7 allows the JPA to issue one 20-year bond issue. The county plans to issue in June 1995, through the JPA, approximately \$155 million in long-term bonds. The

county plans to use the net proceeds of approximately \$150 million, after issuance costs, plus approximately \$108 million currently in reserves to retire the \$175 million of notes due in June 1995. Remaining funds will contribute approximately \$60 million on a one-time basis towards satisfying its \$2.0 billion debt and provide a method to advance future delinquent tax receipts annually. Additionally, the county expects to receive from this program approximately \$10 million annually for the county's general fund. However, the county will require the approval of the bankruptcy court before it can use the proceeds to retire the notes maturing in June 1995.

The county's underwriters developed computer models to test the security of the Teeter financing. We reviewed the assumptions and methodologies that they used to develop the models. Based on our limited review, we concluded that these assumptions and methodologies were reasonable.

- ***Integrated Waste Management System***

The county, through its Integrated Waste Management Department (IWMD), is the sole operator of the municipal solid waste landfill disposal facilities. In the plan, the county proposes to operate the waste management as a business to maximize its value. As a first step, the plan proposes to increase the landfill fees. Following the bankruptcy, the county performed an operational financial review of its waste management system. It included a five-year plan with the goal of operating the landfill system like a business. The review concluded that the current fee of \$22.75 per ton of waste was inadequate to finance the waste management operations over the next five years and that it would be necessary to raise the fees to \$35.00 per ton to support the current cost structure. We did not assess the reasonableness of the assumptions used or the results obtained in the operational financial review. The Board of Supervisors will vote on this fee increase on May 23, 1995.

In addition to raising the fee, the plan proposes importing out-of-county waste. According to the plan, the county's landfills have excess capacity. By importing out-of-county waste to more fully utilize its landfills, the county believes that the waste management system can generate additional cash flows allowing the issuance of up to \$500 million in bonds and providing approximately \$12 to \$24 million in additional general fund revenues. After paying issuance costs and retiring existing IWMD bonds, the county plans to use the remaining proceeds of approximately \$360 million to satisfy some of its \$2.0 billion debt. However, the bankruptcy court must first approve the use of these funds. Additionally, the supervisors must repeal county ordinances prohibiting out-of-county waste.

The amount of bonds the county can issue is dependent upon the volume of waste it can import and the resulting cash flows. The county has distributed to haulers and governmental entities a request for proposal (RFP) which can be used to assess the interest in using the county's waste management facilities; however, the RFPs are not due to the county until May 31, 1995. In addition, after the county receives the RFPs, it will compile a final feasibility study. Consequently, we are unable to assess the reasonableness of the waste management financing at this time.

The financing proposals described below are predicated on the voters' approval of the half-cent sales tax on June 27, 1995, (Measure R).

- ***Motor Vehicle Intercept Financing***

Monthly, the State deposits in a special account the Motor Vehicle License Fees (fees) which it collects and eventually distributes to counties and cities based on a statutory formula. The county's general fund receives approximately \$97 million of these fees annually. Based on annual fees of \$97 million, the county's underwriters estimate that, in addition to the COPs discussed in the Recovery Notes section of this report, the county can issue approximately \$450 million in 30-year debt. After paying the costs of issuance, insurance, and establishing a debt service reserve fund, the county will net approximately \$400 million. With the approval of the bankruptcy court, the county plans to use these proceeds to satisfy some of its \$2.0 billion debt. On May 12, 1995, the governor approved SBX2-18, which allows the county to pledge its fees for payment of debt service.

However, according to the plan, this financing is dependent on the voters' approval of the half-cent sales tax on June 27, 1995. Because the county will use its fees to pay the debt service on the bonds, these revenues will no longer be available to the general fund. As a result, the intercepted general fund fees must be replaced. The plan proposes to replace these fees with increased sales tax revenues of approximately \$130 million annually. Without the increase in the sales tax, the Motor Vehicle Intercept Financing would not be feasible.

- ***Ten-Year Payback Plan***

Finally, the plan indicates that the portion of the \$2.0 billion debt which will not be paid with the proceeds generated by the previously described financings, will instead, be paid over the next ten years. The county plans to pay from its general fund approximately \$100 million annually towards the remaining debt. Again, the

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county's ability to make these payments through its general fund is dependent on the increase in sales tax revenues in addition to any new revenues generated by the restructuring of the Teeter program and the waste management system.

In summary, the county plans to issue various financing instruments that could generate net proceeds of up to \$655 million without the voters' approval of the half-cent sales tax. However, approximately \$400 million in net proceeds is dependent on the voters' approval of the sales tax. Further, once the county and its legal advisors know how much the county will receive from these financings, their legal advisors will submit to the bankruptcy court a plan of adjustment for the court's approval. The plan of adjustment will identify the specific debt to be satisfied with proceeds from the financings and the debt that will be deferred over ten years. The county will need to obtain the court's approval of this plan of adjustment before it can make any payments from its pool of funds.

Sincerely,

KURT R. SJOBERG
State Auditor