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SFA BILL ANALYSIS

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Senate Bill 1506 (as reported without amendment)
Sponsor: Senator Shirley Johnson
Committee: Education

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RATIONALE

Public-private agreements are one way to finance the development of public facilities. In this type of arrangement, a public entity enters into an agreement with a private developer who will construct or renovate a public facility and then lease it to the public entity for a period of time, such as 20 or 30 years. When that time elapses, the public entity takes ownership of the facility for little or no additional charge. The financing of the arrangement may involve the sale of bonds by a public authority, which passes on the proceeds to the developer. The developer, backed by a letter of credit from a financial institution, repays the bonds from the lease payments it receives from the public entity. In effect, the public authority issuing the bonds acts as a conduit for the funding.

While public-private agreements involving authority-issued bonds have become common in the economic development arena, they recently became feasible for the purpose of financing educational facilities. This is the result of amendments to Section 142 of the Internal Revenue Code that added "qualified public educational facilities" to the other public facilities for which tax-exempt bonds may be issued, in order to fund private development of the facilities. (Please see **BACKGROUND**, below, for a more detailed explanation of these provisions.)

In response to the Internal Revenue Code amendments, Governor Engler issued Executive Orders (E.O.s) 2001-11 and 2002-3 to create the Michigan Public Educational Facilities Authority (MPEFA) and empower it to issue bonds and notes for the purpose of financing the construction, rehabilitation, or equipping of public educational facilities. (When technical problems with the 2001 E.O. were revealed, Executive Order 2002-3 rescinded it and re-established the Authority.) To date, the MPEFA has approved "inducement resolutions" for eight developers that have entered into public-private agreements with public schools.

It now has been suggested that the MPEFA should be established in statute for several reasons, such as increasing the comfort level of financial institutions that issue letters of credit, in order to expedite the process.

CONTENT

The bill would create the "Michigan Public Educational Facilities Authority Act" to do the following:

- **Create within the Department of Treasury the Michigan Public Educational Facilities Authority, and transfer to it the powers, duties, functions, and obligations of the MPEFA that was established by Executive Order 2002-3.**
- **Permit the Authority to assist, through financing or refinancing, the construction, acquisition, rehabilitation, refurbishing, and equipping of public schools, as provided in Section 142 of the Internal Revenue Code.**
- **Allow the Authority to issue tax-exempt bonds and notes for the purpose of lending money to, and purchasing obligations issued by, public schools and developers in this or any other state, and for other purposes.**
- **Provide for the Authority's board of trustees.**

- **-- Provide that a public school or developer could contract to pay no interest or interest at a variable rate on money borrowed from the Authority.**
- **-- Allow the Authority to charge a fee for services to a developer or public school.**
- **-- Require the Authority to report annually to the Center for Educational Performance and Information.**

The bill would define "developer" as a person who had entered into a "public-private partnership agreement" with a "qualified public educational facility". The bill would define those terms as they are in Section 142 of the Internal Revenue Code. The Code defines "qualified public educational facility" as any school facility that is part of a public elementary or secondary school, and is owned by a private, for-profit corporation under a public-private partnership agreement with a state or local educational agency. Under a "public-private partnership agreement", the corporation agrees to construct, rehabilitate, refurbish, or equip a school facility and, at the end of the term of the agreement, to transfer the school facility to the state or local educational agency for no additional consideration.

The bill would define "public school" as a public elementary or secondary educational entity or agency established under the Revised School Code, whose primary mission is the teaching and learning of academic and vocational-technical skills and knowledge, and is operated by a school district, a public school academy corporation, a strict discipline academy corporation, the Department of Education, or the State Board of Education. A public school also would include a laboratory school or other elementary or secondary school controlled and operated by a State public university.

Creation of Authority

The bill would create the Authority as a "public body corporate and politic" within the Department of Treasury. Funds of the Authority would have to be handled in the same manner and subject to the same provisions of law applicable to State funds, or in a manner specified in a resolution of the Authority authorizing the issuance of bonds or notes.

The bill would transfer to the Authority, by a type II transfer, all of the powers, duties, functions, responsibilities, debts, and liabilities, including outstanding bonds, notes, and other obligations, of the Michigan Public Educational Facility Authority described in Executive Order 2002-3. (In a type II transfer, functions of an existing entity are transferred to a principal department.)

Board of Trustees

The Authority's purposes, powers, and duties would be vested in and exercised by a board of trustees. The board would consist of the State Treasurer and four members appointed by the Governor with the advice and consent of the Senate. (Until all board of trustees members were appointed and took office, however, the members of the MPEFA board serving under Executive Order 2002-3 would be members of the Authority board.) Not more than two of the appointed trustees could be members of the same political party. Trustees would hold office for a four-year term or until a successor was appointed, whichever was later. Of the initial members, however, the Governor would have to designate two to serve for four years, one for three years, and one for two years.

The Governor would have to designate one board member to serve as its chairperson, at the pleasure of the Governor. A majority of board members would constitute a quorum for the transaction of business, and actions of the board would have to be approved by a majority vote of the members present at a meeting. The board would be subject to the Open Meetings Act.

The trustees would have to serve without compensation but could receive reasonable reimbursement for necessary travel and expenses incurred in the discharge of their duties, according to the relevant provisions of the Civil Service Commission and the Department of Management and Budget.

The Authority could employ or contract for legal, financial, and technical experts, consultants, and an executive director, officers, agents, and employees as the Authority required, and would have to determine their qualifications, duties, and compensation. Board members and Authority officers and employees would be subject to Public Act 317 of 1968 (which prohibits public

servants from being party to a contract with a public authority, subject to certain exceptions). Board members and Authority officers and employees would have to discharge their duties in a nonpartisan manner, with good faith, and would be subject to a prudent person standard.

As appropriate, the board could make inquiries, studies, and investigations, hold hearings, and receive comments from the public. The Freedom of Information Act would not apply to a record or portion of a record, material, information, or other data received, prepared, used, or retained by the Authority in connection with an application to it, or a project related to an application that related to trade secrets, commercial, financial, or proprietary information submitted by the applicant, and that was requested by the applicant and acknowledged by the executive director of the Authority to be confidential. "Trade secrets, commercial, financial, or proprietary information" would mean information that had not been publicly disseminated or that was unavailable from other sources, whose release could cause the applicant competitive harm.

Authority Powers

The Authority's powers would include all those necessary to carry out and effectuate the purposes of the proposed Act, including the power to do the following:

-- Borrow money and issue bonds and notes to finance or refinance part or all of the costs of construction, acquisition, rehabilitation, refurbishing, or equipping public schools, and the renovation and remodeling of public schools.
-- Invest any money of the Authority at its discretion, in any obligations it determined proper.
-- Receive and accept from any source grants or contributions of money, property, or other things of value for the purposes described in these provisions.
-- Lend money to a public school or a developer at a rate or rates as the Authority determined; as well as purchase and sell, and commit to purchase and sell, obligations described in the bill.
-- Acquire from any person interests in real or personal property necessary for operation of the Authority.
-- Procure insurance against any loss in connection with the property, assets, or activities of the Authority.
-- Indemnify and procure insurance indemnifying any Authority board members from personal liability by reason of their service as a board member.
-- Sue and be sued, and execute contracts, conveyances, and other instruments necessary to the exercise of the Authority's powers.
-- Adopt and amend bylaws.
-- Engage the services of consultants on a contractual basis.
-- Enforce financial, operational, warranty, security, lease, and guaranty terms and conditions established under financings by the Authority.

The Authority would exercise its duties independently of the State Treasurer, although the Authority's budgeting, personnel, procurement, and related administrative functions would have to be performed under the Treasurer's direction and supervision. By written instrument, the State Treasurer could delegate a duty or power conferred by law to a person as determined by the Treasurer.

Bonds & Notes

The Authority could issue Authority bonds or notes in the principal amounts it considered necessary to provide funds for any purpose, including the following;

-- Making loans to public schools and developers in this or any other state.
-- Purchasing obligations issued by developers and public schools in this or any other state.
-- Paying, funding, or refunding the principal of, interest on, or redemption premiums on Authority bonds and notes.
-- Establishing or increasing reserves to secure or pay Authority bonds or notes or interest on them.
-- Paying interest on the Authority bonds or notes for a period it determined.
-- Making loans to public schools for short-term borrowings under Section 1225 of the Revised School Code (which provides for loans to fund school operations or pay previous loans obtained for school operations).
-- Making other expenditures necessary to carry out the Authority's duties, including

paying its operating expenses.

Authority bonds or notes would not be a general obligation of the Authority and would be payable solely from the revenues and/or funds pledged to the payment of the principal of and interest on the bonds or notes, as provided in the authorizing resolution. Authority bonds or notes also could be secured by a pledge of any grant or contributions from the United States, this State, a governmental unit, or any person, firm, or corporation, or by a pledge of income or revenues, funds, or money of the Authority from any source whatsoever.

Authority bonds and notes would not be in any way a debt or liability of this State, and would not create or constitute any indebtedness, liability, or obligations of this State or constitute a pledge of the State's faith and credit.

The notes and bonds would have to be authorized by resolution of the Authority and mature at the time provided in the resolution. They would have to be in a form, bear interest at a rate or rates, be in the denominations, carry registration privileges, be payable, and be subject to the terms of redemption as provided in the resolution. The resolution could contain provisions described in the bill.

The Authority could sell its bonds or notes at public or private sales at prices it determined. The Authority could create and establish one or more special funds as reserve funds to secure notes and bonds, as provided in the bill. The Authority could enter into an interest rate exchange or swap, hedge, or similar agreement or agreements in connection with the issuance of its notes or bonds or with its then outstanding notes or bonds.

An Authority bond or note would not be subject to the Revised Municipal Finance Act, but the issuance of bonds and notes would be subject to the Agency Financing Reporting Act. The notes and bonds would be negotiable instruments within the meaning of the Uniform Commercial Code, whether or not they were of a form or character of negotiable instruments.

The members of the board or any person executing notes or bonds under the proposed Act, would not be personally liable on the notes or bonds, or subject to any personal liability or accountability by reason of their issuance.

If the Authority defaulted in the payment of principal of or interest on any notes or bonds when due, and the default continued for 30 days, or if the Authority failed or refused to comply with the proposed Act, or defaulted in any agreement made with the holders of the notes or bonds, the holders of 51% or more of the notes or bonds of that issue then outstanding, could apply to the Ingham County Circuit Court for the appointment of a trustee to represent the holders. A trustee would have the powers and duties described in the bill.

<u>Developers & Public Schools</u>

A public school or developer could borrow money and issue obligations in accordance with the laws of this State. The security for obligations would have to be that provided by the laws authorizing their issuance.

The Authority could lend money to a developer or a public school by purchasing obligations of the developer or the school. The Authority could require a developer or public school to pledge, and the developer or school could pledge, for the payment of the purchased obligations money received or to be received by the developer or the school, whether derived from the imposition of taxes by the State or from other sources and returned to the developer or school, as provided by law. A developer or school, however, could not pledge money whose use for these purposes was prohibited by the State Constitution. If the Authority and a public school entered into an agreement, the State Treasurer would have to pay the pledged money according to the agreement.

Notwithstanding any provisions of a charter or statute applicable to, or constituting a limitation on, the maximum rate of annual interest payable on bonds or notes, or as to annual interest cost of money borrowed or received upon issuance of bonds or notes, a public school or developer could contract to pay no interest or variable interest on money borrowed from the Authority and evidenced by the obligations it purchased. A public school or developer could contract with the Authority with respect to a loan from, or an obligation purchased by the Authority. The contract also could provide for agreements by the school or developer with respect to its fiscal, budget, debt and cash management, and accounting matters as the Authority requested.

The Authority could charge a fee for a public school or developer to use its services. A public school would be authorized to pay the fee.

Unless approved by a concurrent resolution of the Legislature, the Authority could not provide preferential treatment in the rate of interest for a particular obligation purchased by it that was based upon other than financial and credit considerations, and could not consider or relinquish all or part of the interest or principal of a particular obligation or of obligations of a particular purpose.

Other Provisions

The Authority would have to prepare and submit an annual report to the Center for Educational Performance and Information (a temporary State agency created by Executive Reorganization Order 2000-6). The report would have to include the total number and dollar amount of bond issues, the number of schools assisted, the geographic distribution of the bond financing, and the types of facilities financed.

All expenses incurred in carrying out the provisions of the proposed Act would be payable solely from revenues or funds provided or to be provided under the Act. Nothing in the Act could be construed to authorize the Authority to incur any indebtedness or liability on behalf of or payable by the State.

The State would covenant with the purchasers and all subsequent holders and transferees of bonds and notes issued by the Authority, that the bonds and notes and the income from them, and all of its fees, charges, grants, revenues, receipts, and other money received, pledged to pay or secure the payment of the bonds and notes, would be exempt from all State, city, county, or other taxation.

The bill specifies that the property of the Authority and its income and operation would be devoted to an essential public and governmental function and purpose, and would be exempt from all taxation and special assessments by the State or any of its political subdivisions.

BACKGROUND

Section 142 of Internal Revenue Code

Amendments to Section 142 of the Internal Revenue Code were part of the Economic Growth and Tax Relief Reconciliation Act of 2001. As explained in the House Conference Report, interest on bonds that are nominally issued by states or local governments, but whose proceeds are used by a private person and whose payment is derived from funds of that person, is taxable unless the purpose of the borrowing is specifically approved in the Code or in a non-Code provision of a revenue act. These bonds are called "private activity bonds".

The law includes several exceptions permitting states and local governments to act as conduits providing tax-exempt financing for private activities. States and local governments may issue tax-exempt "exempt facility bonds" for certain types of private businesses, such as transportation, privately owned and/or operated public works facilities, and privately owned and/or operated low-income rental housing. In most cases, the aggregate volume of private activity tax-exempt bonds is restricted to annual aggregate volume limits imposed on bonds issued within each state. The volume limits are based on a state's population and indexed annually for inflation.

Section 142 of the Code defines "exempt facility bond" for these purposes. At least 95% of the net proceeds of a bond issue must be used to provide the types of facilities listed in the definition. The 2001 amendments expanded this list to include qualified public educational facilities. The issuance of these bonds is subject to a separate annual per-state private activity bond volume limit equal to $10 per resident, in lieu of the standard state private activity bond volume limits. States may decide how to allocate the bond authority to state and local government agencies.

Existing Authority

The Michigan Public Educational Facilities Authority, created by Executive Orders 2001-11 and 2002-3, is located within the Department of Treasury and exercises its powers independently of the State Treasurer.

The MPEFA is governed by a board of trustees consisting of the State Treasurer and four trustees appointed by the Governor with the advice and consent of the Senate. Not more than two of the appointed trustees may belong to the same political party.

The Executive Orders transferred to the MPEFA and its board of trustees all of the statutory powers and responsibilities of the Michigan Strategic Fund and the Fund's board of directors with respect to a commercial enterprise involving the construction, rehabilitation, refurbishing, or equipping of school facilities that were occupied or to be occupied by a public school, including the power to issue bonds and notes and enter into contracts.

The E.O.s also transferred to the MPEFA and its board the statutory powers and responsibilities of the Michigan Municipal Bond Authority and its board regarding public school academies, laboratory schools, and other elementary or secondary schools controlled by a public university, including the power to issue bonds and notes and enter into contracts.

In addition, the Executive Orders designated to the MPEFA the allocation of volume limitations for exempt facility bonds relating to qualified public educational facilities. (For the State of Michigan, approximately $99.4 million may be issued in these bonds.)

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

The issuance of tax-exempt bonds for school construction and improvement, under a public-private partnership agreement, is cost-effective for both developers and schools. The existing MPEFA compared the costs of financing a $5.2 million school project under a public-private partnership agreement versus a conventional bond issue, assuming a 30-year amortization period. In this example, the MPEFA issues $4.285 million and the developer's equity is $1.3 million, while $7.26 million in bonds is issued under the conventional approach; this means that the total sources of funds are $1.675 million less under the public-private agreement. Based on factors detailed in the cost comparison, it also showed that up-front uses of the funds are $1.675 million lower under the public-private agreement. Over the 30-year amortization period, the net debt service is almost $10 million lower for MPEFA-issued bonds, and the developer's equity is $6.125 million (based on a negotiated rate of return of 15%). As a result, the total debt service over 30 years is *$3.835 million less* under the public-private agreement, which obviously produces lower costs for the developer and the school. Also, the school has a way to fund facility construction that does not require the school to seek approval of its own bond issue, obtain another source of funding, or otherwise incur additional debt. At the same time, the State itself does not incur liability for the bonds, but simply acts as a conduit for the financing, and investors earn tax-exempt income.

While this method of financing already is in place, and the necessary steps toward bond issuance are being taken, establishing the Authority and bonding provisions in statute would improve the process in several ways. Developers that have entered into public-private agreements with schools must obtain a letter of credit from a financial institution before the MPEFA will issue bonds. Under any circumstances, this undertaking can be time-consuming and demanding, and is even more so when the financial institution is reluctant to go forward due to the absence of statutory provisions. By creating the Authority in statute and enacting extensive, detailed bonding language, the bill would encourage financial institutions to issue the letters of credit needed before the MPEFA issues bonds.

This proposal also would allow the Authority to charge a fee for its services. Although the MPEFA already may do so, this power would be explicit under the bill. Because the bond issuance process is highly complicated, and the use of tax-exempt private activity bonds for public educational facilities is very new, Michigan's Authority could generate revenue by acting as a consultant to other states. According to the current director of the MPEFA, it is close to completing the process with two developers. After the developers receive their letters of credit, the MPEFA will require about 30 days to issue the bonds. Michigan's Authority then will be the first in the nation to issue exempt facility bonds for qualified public educational facilities.

Further, the bill would enable the Authority to obtain funding by engaging in transactions with out-of-State developers and schools. According to the director, the Authority must be able do so in order to apply for Federal grant funds for debt reserve.

The bill would transfer the existing MPEFA intact to the Authority created in statute, as well as retain its current powers and the structure of its board of trustees. In addition to enacting detailed bonding provisions, the bill clearly would spell out what the Authority would be required or permitted to do, the powers and duties of its board of trustees, and the liability and responsibilities of developers and public schools. The bill also would make it clear in statute that Authority bonds and notes would not in any way be a debt or liability of the State.

Legislative Analyst: Suzanne Lowe

FISCAL IMPACT

Since the MPEFA is already in operation pursuant to Executive Order 2002-3, this bill would have no fiscal impact on State or local government. Revenue for operational costs of the Authority would be available from fees charged to public schools or developers for use of the Authority's services. At this time, the salaries of the MPEFA's two staff persons, the director and a financial specialist, constitute the operational costs. The State is not liable for debt of the Authority and the bill would maintain that separation.

Fiscal Analyst: Jessica Runnels

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.