

A REPORT ON THE TEETER PLAN

How did we get to this point?

March 21, 2012

Summary

The Teeter Plan (Plan) as adopted by the County of Mendocino (County) authorizes the County to distribute the property tax billings to the various public entities that receive portions of the tax, without regard to the actual collections.

The Plan called for the County to assume the responsibility of delinquent taxpayers' missed or late payments of their real estate and personal property taxes. By assuming this responsibility, the County got to keep the tax, penalties and interest once the delinquencies are paid. This is a win-win situation for the County and the Special Districts (SD).

In interviewing the various County Officials, it is clear that each Official viewed the Plan and the payments on the Plan differently. The GJ was informed that Bond Counsel was not consulted in either the creation or continuation of the Plan. The GJ is calling for consultation with Bond Counsel on the Plan and all consideration of Plan changes.

While some County Officials have insisted that the Plan debt was not borrowing from the County Investment Pool (Pool), the GJ sees it as borrowing, as it reduced the amount of funds available to the Pool for investment in interest earning accounts. In addition, the County in materials presented at the March 13, 2012, Board of Supervisors meeting, acknowledged this as borrowing. The interest that the County was paying on an ever-increasing debt was less than what the Pool could have earned from a similar long-term investment.

Why is this important? The answer has to do with the amount of interest the County has been paying to the Pool. Since June 30, 1993, a period of approximately nineteen years, the County has been paying interest at a short-term rate. The County's short-term interest rating, from the various entities that rate the County, has historically been good. Thus, the interest paid on the Plan notes has been less than half of the amount that would have been paid if the County had recognized the Plan as a long-term note.

The original Plan note was for a putative one-year period with rollover provisions for another six years. The apparent intention was to limit the exposure of the County on interest payments to a short-term basis. The reality of this note was that the County planned to pay off the note over a five-year period. This is evidenced by the payment plan that was started prior to the actual adoption of

the note. It is difficult for the GJ to see these Plan notes as anything less than a long-term obligation for the County.

On June 30, 2000, the County made a significant payment on the debt as of the expiration of the original note, which exceeded for the first time the actual delinquency for that fiscal year. Unfortunately, this action was not to be repeated for two years with significant increases to the debt. The debt increased by more than \$2.7 million between June 30, 2000 and June 30, 2008.

If Bond Counsel determines the debt is long term, then the interest payments that have totaled hundreds of thousands of dollars each year may be doubled. The GJ is calling for the County to calculate and restore to the Pool those amounts of interest that have not been paid and to formally recognize that the debt represented by the expired notes is a long-term obligation of the County.

Method

The GJ reviewed documents, budget printouts, tax records, copies of memos and other internal correspondence, various code sections, the California Debt Issuance Primer, interviewed County officials and attended a meeting of the Investment Pool.

Background

The County decided to participate in the Plan method of financing county and SD funding in 1993. This decision was prompted by the State of California (State) agreeing to pay start up funding of approximately \$2,000,000 and a need for additional funds to pay for the outstanding delinquent property tax at the time of \$5,426,949.

The County recognized there was a very short time frame in which to initiate the Plan at the start of fiscal year 1993-1994. With the assistance of County Counsel, the Chief Administrative Officer (CAO) initiated the Plan by presenting to the Board of Supervisors a Teeter Plan Tax Revenue Anticipation Note. This note was to enable the County to use the Pool as the funding source for the start up of the Plan as the payment from the State was less than the funds needed to pay for the debt load the County was about to absorb.

The original payment plan was five payments of \$1,080,000 with the first payment as of June 30, 1993. The other payments were made on June 30 of each of the following four fiscal years.

When the County borrows funds from an external source, the interest rate is computed on a non-taxable rate – i.e.: a municipal bond rate. If the County borrows funds from an internal source, the interest rate is computed on a taxable rate – i.e.: a corporate bond rate. The difference between these two rates is

about double, assuming that the credit rating for each is the same. Also, the interest rate for a long-term debt is about double the interest rate for a short-term debt at the same credit rating level. This means that the interest paid to date may be, at best, only half of the amount that should have been paid.

On November 1, 1993, the County formally adopted the Plan with the original buy out of \$5,426,949 of debt resulting from the amount of delinquent tax assessments. The planning for this event was started in June 1993, and included memos from County Counsel to the CAO discussing the need for each SD to sign off on the Plan. The GJ located 22 records showing that the original instruction from County Counsel to obtain written agreement from two-thirds of the Boards for the SD was followed.

The original note, #1993-1, was issued on November 1, 1993, to the Pool. The borrowing was done by creating a fund that reflected a negative balance of \$5,426,949 and an initial payment of \$1,080,000 on June 30, 1993 (this was prior to the establishment of the debt). Over the next four years the Plan debt grew as the County continued to place the delinquent tax accounts into the Plan while only making the payments required under note #1993-1

How to pay for the increasing debt was the problem. The County, by maintaining the Plan fund in a deficit balance, added to the outstanding Plan debt by failing to replenish the Plan fund each year from the General Fund as of the start of each fiscal year. From June 30, 1994, through June 30, 1999 the Plan fund grew from a negative balance of \$5,219,674 to a negative balance of \$9,350,693, as the payments on the Note did not match the increased borrowing from the Pool.

The original note, #1993-1, expired on June 30, 2000. The Board of Supervisors did not renew the note until May 2003, when they issued note #2003-1. This new note had a period of 7 possible renewals. This note expired on April 1, 2011. The County Staff does not view the Plan as a note but rather as a fund with a negative balance. As of the date of this report, the Board of Supervisors has not issued a new note.

From June 30, 2000, until June 30, 2008, the Plan debt grew from \$8,540,095, to \$11,243,824. Then for fiscal year ending June 30, 2009, the Board of Supervisors decided to begin paying the Plan in full each current year from the General Fund while concurrently paying the interest and penalty amounts collected to the Plan fund. This will eventually eliminate the debt entirely as a long-term obligation.

The repayment decision has resulted in the reduction of the Plan debt from \$11,243,824 to \$8,451,543.82, as of June 30, 2011. The reduction has been based on the payment from the General Fund to the Plan fund of \$769,204.73 each year with additional payments each year reflecting the amount of interest

and penalties collected each year. These additional payments have totaled \$484,666.00 for the years of 2010 and 2011 combined.

At the same time, the payment of interest was changed from being part of the principal payment. It is computed separately and paid to the Pool through another fund. This interest has been computed on a short-term basis rather than a long-term basis.

Findings

1. County Counsel recommended in a memo to the CAO in 1993 that written agreements to participate in a Teeter Plan be obtained from two-thirds of the participants in the Pool before adopting the Teeter Plan.
2. The GJ found written agreements from 22 Pool participants regarding the Teeter Plan.
3. The County never sought judicial approval in adopting the Teeter Plan as suggested in the *California Debt Issuance Primer*.
4. The Plan funding Note #1993-1 was issued on November 1, 1993 and expired on June 30, 2000.
5. The Plan funding Note #2003-1 was issued on May 23, 2003 and expired on April 1, 2011.
6. The Plan debt increased from the initial debt of \$5,426,949 on November 1, 1993 to a high of \$11,243,824 on June 30, 2008.
7. Interest payments on the Plan debt are computed on a short-term basis.
8. The Plan debt has been in existence for approximately 19 years.
9. Short-term notes are issued for periods of one year or less.
10. Long-term notes are issued for periods of over one year.
11. During fiscal year 2011-2012, the County's long-term credit rating was lowered to BBB-, just above junk bond status.
12. At the November 8, 2011 Board of Supervisors meeting, it was announced that the County couldn't get refinancing on Certificates of Participation (COPs) because the County can't get insurance for refinancing due to the long-term credit rating.
13. However, at the March 13, 2012 meeting, the Board of Supervisors announced that the Insurance Company reconsidered their position and agreed to cover the COPs. This change of position was a result of the over 400 employee layoffs and other cost saving actions taken to balance the budget by the Board of Supervisors.
14. The background information regarding the Plan supplied to the Board of Supervisors for this meeting, entitled "Preliminary Official Statement Dated (POS Date)", states on page 50 that the County, "...borrowed from the County Treasury" to fund the Plan.
15. The numbers supplied to the Board of Supervisors in anticipation of the November 8, 2011, meeting, which were prepared on October 4, 2011, were not in agreement with the printout of the actual Teeter Receivable worksheet supplied to the GJ.

16. In interviews, Board of Supervisors members were not initially aware of the expiration of either Note #1993-1 or Note #2003-1. It was not clear whether any of the members interviewed were aware of the existence of the notes prior to the interviews.
17. It did not appear that any of the current County officials responsible for administering the Plan, who were interviewed by the GJ, were initially aware of the notes or the respective expiration dates prior to contact by the GJ.
18. Communications among the County Treasurer, County Auditor, County Counsel and the Board of Supervisors are lacking in clarity on the issue of the Plan debt.
19. Their respective predecessors historically train the County Auditor and County Treasurer.
20. The GJ did not find evidence that any current County employee has ever been specifically trained in Teeter Plan financing.
21. Most of the interviewees the GJ spoke to appeared to be (initially) unacquainted with the California Debt Issuance Primer (CDIP).
22. The CDIP calls for interest on internal borrowing to be computed at a taxable rate.
23. The Plan, as adopted by the County, uses internal borrowing.
24. A taxable rate is the rate at which the interest on corporate bonds is computed.
25. A non-taxable rate is the rate at which the interest on municipal bonds is computed.
26. Short-term rates are less than long-term rates.
27. Interest on municipal bonds is less than the interest on corporate bonds of the same credit rating and life of the bonds.
28. For fiscal year 2008-2009, the Board of Supervisors decided to adopt a long-term repayment plan to eliminate the Plan debt. The initial repayment plan was for an additional 19-year period.
29. This was changed to a new projected payment date per the adopted repayment plan document to July 1, 2022, a thirteen-year period.
30. According to the County Auditor Staff, they anticipate actual repayment of the Plan debt within the next five to seven years. This is accomplished by a fixed payment each year with additional payments based on receipt of payment of interest and penalties from the delinquent taxpayers.
31. The County is currently paying interest on the Plan debt at a taxable short-term rate.

Recommendations

The GJ recommends that:

1. The County hires a Bond Counsel to advise them on how to handle the historical Plan debt. (Findings all)

2. If the Bond Counsel so advises, the Board of Supervisors issue formal recognition of the Plan debt as a long-term obligation of the County. (Findings 4-5, 8-10, 28-31)
3. If the Bond Counsel so advises, the Board of Supervisors corrects the historical underpayment of interest to the Pool. (Findings 7-11, 24-31)
4. The Board of Supervisors continues to pay off the Plan debt as quickly as possible using the current repayment plan. (Findings 28-30)
5. If the Bond Counsel so advises, the Board of Supervisors provide for the payment of the proper amount of interest to the Pool for all future years reflecting the fact that the County's current long-term credit rating is BBB-. (Findings 7-13, 24-31)
6. In all presentations to the Board of Supervisors, the respective elected County Officials provide accurate, concise and meaningful documentation for the Board of Supervisors regarding the Teeter Plan debt and particular areas of exposure to increases in defaults. (Findings 12-20)
7. The Plan debt continues to be reflected in the budget as a separate line item until eliminated by the completion of the current payment plan in the interest of transparency. (Findings 15-18, 28-30)

Discussion

Much of the GJ concerns with the Plan and how it has been handled in the past are stated in our summary section. The Teeter Plan has been a boon, for the most part, to the SD that are in the investment pool. In that, the SD got their operating funds at the start of the fiscal year rather than having to wait until the money came in. Thus, they were assured of at least the amount on which their respective budgets were planned.

The County benefited by being able to keep the tax, interest and penalty amounts collected each year. This supplied the County with additional and somewhat unanticipated funds to fill gaps in its budget.

While the County made some payment in each year from 1993 through 1997, no payment on the debt was made in 1998. Payment was resumed in 1999 and a significant payment was made in 2000. However, the payments from 1993 through 1999 were less than the amounts added to the debt over the period. It is difficult for the GJ to see these events as unanticipated.

What was unanticipated were the hits to the national economy in 2000 from the Dot Com crash, 2001 from the attack on the World Trade Center and the credit default swap – mortgage backed securities collapse in 2008. Each of these hits

to our national economy led to increases in defaults in tax payments at a local level.

Each increase in defaults created a larger burden on the County to collect the funds from the taxpayers that had been advanced to the SD. While the County has done well in collecting these amounts, the County did not credit all of the collections back to the Plan debt in years prior to 2008. It used the funds collected to meet other County expenses. This led to the increase in the debt balance.

Now the County faces the concern of taxpayers walking away from properties that are underwater – the debt load on the property is higher than the value of the property on the market. When the County tries to sell these properties, the offers (if any) are less than the outstanding debt. This is especially true of undeveloped and/or unbuildable land.

This brings us to the GJ concern with the assumption that the Plan is a short-term debt. Since the evidence of how the County originally planned to pay the debt shows that the intention to pay the Plan was over five years, it is highly unlikely that the Plan is short-term. This means the County has consistently underpaid the amount of interest due to the Pool by at least half of the amount truly due for the past nineteen years.

The Pool consists of funds placed there by the County and most, if not all, of the SD in the County. These SD include the School Districts, Water and Sewer Districts that cover county areas outside of any City, some Fire Districts that cover county areas, Cemetery Districts and other special districts. These SD's have contributed approximately 75% of all of the funds contained in the Pool.

Thus, at least 75%, on average, of the interest portion of the payments on the Plan are due to these SD. This is a significant amount of money. It enables the SD to meet expenses that were not budgeted and other emergency costs. It also enables the SD to fund some budgeted expenditures without having to borrow when revenues fall short of expectations.

The Pool participants have been deprived of needed funds to help fill the gaps in their current budgets that could and should have been supplied by the payment of the proper amount of interest on the Plan debt over the past two decades.

If the Bond Counsel so advises, the GJ calls for the County to pay that past due amount and make the Pool participants whole.

Required Responses

Mendocino County Auditor (Findings 1-11, 15, 17-31; Recommendations, All)

Mendocino County Tax Collector/Treasurer (Findings 2-15, 17-31;
Recommendations All)

Mendocino County Counsel (Findings 1-5, 7-14, 18, 22; Recommendations 1-3,
5-6)

Mendocino County Chief Executive Officer (Findings 1-15, 18, 20, 22-31;
Recommendations All)

Board of Supervisors, Mendocino County (Findings 1-16, 18, 20-31;
Recommendations All)