City of Huntington Beach
Debt Management Policy

PURPOSE

- The purpose of this Debt Management Policy ("Policy") is to establish guidelines and parameters for the effective governance, management and administration of the debt of the City of Huntington Beach ("City"). This Policy is intended to comply with California Government Code Section 8855(i), and any successor statute, and shall govern all debt which is contemplated or incurred by the City.
- The City hereby recognizes that a fiscally prudent Policy is required to:
  - Maintain the City's sound financial position;
  - Ensure the City has the flexibility to respond to changes in future service priorities, revenue levels, and operating expenses;
  - Protect the City's creditworthiness;
  - Ensure that all debt is structured to protect both current and future taxpayers, ratepayers and constituents of the City; and
  - Ensure that the City's debt is consistent with the City's strategic planning goals, objectives, capital improvement program, and/or budget.

BACKGROUND

- The City is committed to fiscal sustainability by employing long-term financial planning efforts, maintaining appropriate reserves levels and employing prudent practices in governance, management, budget administration and financial reporting.
- Debt levels and their related annual costs are important long-term obligations that must be managed within available resources. A disciplined, thoughtful approach to debt management includes policies that provide guidelines for the City to manage its debt consistent with available and reasonably anticipated resources. Therefore, the objective of this Policy is to provide written guidelines concerning the amount and type of debt which may be issued by the City and the ongoing management of debt obligations.
- This Policy is intended to make all relevant information readily available to decision-makers and the public to improve the quality of decisions, provide justification for the structure of debt issuances, identify policy goals and demonstrate a commitment to long-term financial planning, including a multi-year capital plan. Adherence to a Policy signals to rating agencies and the capital markets that the City is well managed and able to meet its obligations in a timely manner.

RELATIONSHIP OF DEBT TO CAPITAL IMPROVEMENT PROGRAM AND BUDGET

- The City has established long-term plans for replacing aging physical infrastructure. The City strives to maintain a level funding plan that will minimize the peaks and valleys in General Fund support levels and allows the funding of projects over time. The City utilizes debt obligations only after giving due consideration to all available funding sources, including, but not limited to, available cash reserves, available current revenues, potential future revenue sources, existing and potential grants, and all other financial sources legally available to be used for such purposes. When and if deemed an appropriate alternative, the City may issue debt for the purposes stated in this Policy to implement policy decisions incorporated in the City's Capital Improvement Program budget adopted by the City Council on an annual basis.

- The City shall strive to fund the upkeep and maintenance of its infrastructure and facilities due to normal wear and tear through the expenditure of available operating revenues. To the extent practicable in the circumstances, the City will avoid the use of debt to fund infrastructure and facilities improvements that are the result of normal wear and tear. Rather, those readily anticipated infrastructure and facilities repairs and replacements should be funded through reserve policies.
- The City shall coordinate its debt issuances with the goals of its Capital Improvement Program by timing the issuance of debt to ensure that project funding is available when needed in furtherance of the City's public purposes.

POLICY GOALS RELATED TO PLANNING GOALS AND OBJECTIVES

- The City is committed to long-term financial planning, maintaining appropriate reserve levels, and employing prudent practices in governance, management, and budget administration. The City intends to issue debt only for the purposes stated in this Policy and to implement policy decisions incorporated in the City's Capital Improvement Program. Adoption of this Policy will help ensure that debt is issued and managed in a manner that protects the public interest.
- It is a policy goal of the City to protect taxpayers, ratepayers (if applicable) and constituents by utilizing conservative financing methods and techniques so as to obtain the highest practical credit ratings (if applicable) and the lowest practical borrowing costs.
- The City shall comply with applicable state and federal law as it pertains to debt and the procedures for levying and imposing related taxes, assessments, rates, or charges.

CONDITIONS AND PURPOSES OF DEBT ISSUANCE

- Acceptable Conditions for the Use of Debt

  The City believes that prudent amounts of debt can be an effective means of financing major infrastructure and capital project needs of the City. Debt will be considered to finance such projects if:

  - It meets the City's goal of distributing costs of the asset over its useful life so that benefits more closely match costs for both current and future residents.
  - It is the most cost-effective funding means available to the City, taking into account cash flow needs, maintenance of prudent reserves and other funding alternatives.
  - It is fiscally prudent and meets the guidelines of this Policy, the City's Municipal Code, and the City's Charter. Any consideration of debt financing shall consider financial alternatives, including pay-as-you-go funding, proceeds derived from development or redevelopment of existing land and capital assets owned by the City, and use of existing or future cash reserves, or any combination thereof.

- Purposes for Which Debt May Be Issued

  The City may consider financing for the acquisition, substantial refurbishment, replacement or expansion of physical assets, including land improvements. The primary purpose of debt would be to finance one or more of the following:

  - Acquisition and or improvement of land, right-of-way, leaseholds or long- term easements.

- Acquisition of equipment or a capital asset with a useful life of three (3) or more years.
- Construction or reconstruction of a facility.
- Refunding, refinancing, or restructuring debt, subject to refunding objectives and parameters discussed herein.
- Although not the primary purpose of the financing effort, project reimbursable costs that include project planning, design, engineering and other preconstruction efforts; project-associated furniture, fixtures and equipment; capitalized interest, original issuer's discount, underwriter's discount and other costs of issuance.
- Interim or cash flow financing, such as tax, revenue or bond anticipation notes.

❑ Prohibited Uses of Debt

Prohibited uses of debt include the following:

- Financing of operating costs except for anticipation notes with a term of less than one year.
- Debt issuance used to address budgetary deficits.
- Debt issued for periods exceeding the useful life of the asset or projects to be financed.

❑ Approval Process for the Issuance of Debt

Any issuance of debt, either through a public sale of securities, private placement or direct purchase is subject to the formal approval of the City Council as a non- consent item on a City Council agenda. As part of the City Council approval, a formal resolution authorizing the issuance of a specific form of debt shall be required as part of the authorizing documents. The resolution shall include, at a minimum, the following:

- The specific project(s) for which the debt is being incurred;
- The maximum principal amount to be borrowed;
- The maximum term, which will be no greater than the useful life of the project(s), equipment, or capital asset, whichever is applicable and longer;
- The maximum interest rate or true interest cost;
- The maximum annual debt service;
- Estimated Costs of Issuance; and
- Maximum Underwriter's Discount.

❑ In addition to the authorizing resolution, the City Council shall be provided copies of the various financing documents including indentures, purchase agreements and preliminary official statements.

STRUCTURE OF DEBT (FIXED RATE)

❑ **Term of Debt** – Unless financially beneficial to do otherwise, debt shall be structured with the goal of spreading payments for the project, equipment, or capital asset over its useful life so that benefits more closely match costs for both current and future residents. The duration of borrowings by the City shall not exceed the useful life of the project, equipment, or capital asset it finances. The standard term of long-term borrowing is typically fifteen to thirty years.

- **Pace of Debt Payment** – Accelerated repayment schedules reduce debt burden faster and reduce total borrowing costs. Debt repayment shall be amortized through the most financially advantageous debt structure and, if applicable, to match the City's projected cash flow to the anticipated debt service payments, to the extent possible. "Backloading" of debt service should be considered only when one or more of the following occur:
  - Natural disasters or extraordinary or unanticipated external factors make payments on the debt in early years impractical.
  - The benefits derived from the debt issuance can clearly be demonstrated to be greater in the future than in the present.
  - Such structuring is beneficial to the City's aggregate overall debt payment schedule or achieves measurable interest savings.
  - Such structuring will allow debt service to more closely match project revenues during the early years of the project's operation.
- **Level Payment** – To the extent practical, bonds will be amortized on a level repayment basis, and revenue bonds will be amortized on a level repayment basis considering the forecasted available pledged revenues to achieve the lowest rates possible. Bond repayments should not increase on an annual basis in excess of two percent (2%) without a dedicated and supporting revenue-funding stream.
- **Serial Bonds, Term Bonds, and Capital Appreciation Bonds** – For each issuance, the City shall select serial bonds or term bonds, or both. On the occasions where circumstances warrant, Capital Appreciation Bonds ("CAB") may be used. The decision to use term, serial, or CAB bonds shall be based on market conditions.
- **Reserve Funds** – The City shall strive to maintain a fund balance or other designated reserve at a level equal to or greater than the maximum annual debt service of existing obligations.
- **Capitalized Interest** - The City shall seek to avoid the use of capitalized interest, which defers debt service by increasing the size of a debt issue to fund interest. On occasion, capitalized interest may be considered to the extent that the City wishes to defer the beginning of debt service until project completion, to match project revenues with debt service.
- **Discount Bonds** - While discount and deep discount bonds may reduce the interest cost of the bonds below that of par or premium bonds, they should only be used in limited situations as they reduce the potential for future savings from refunding of the bonds.
- **Premium Bonds** - Premium bonds may provide for a lower overall interest cost compared to par or discount bonds. An analysis should be prepared comparing the yield to maturity and yield to call of the premium bond structure compared to alternative couponing. This comparison should be done on maturity-by-maturity basis. The value of the call option of the higher coupon with respect to the future ability to refund should be reviewed as well.
- **Call Provisions** - In general, the City's debt obligations should include an optional redemption feature at par that arises not later than ten (10) years after the issuance of the debt. This option may permit the City to achieve higher interest savings in the future through the refunding of the bonds. It is the City's intent to maximize prepayment flexibility on all bond issues. Because the cost of call options can vary depending on market conditions, an evaluation of factors will be conducted in connection with each issuance and shorter call provisions may be considered on a case-by-case basis.

USE OF ALTERNATIVE DEBT INSTRUMENTS

- The City recognizes that there are numerous types of financing structures and funding sources available, each with specific benefits, risks, and costs. All potential funding sources shall be reviewed by management within the context of this Policy and the overall portfolio to ensure that any financial product or structure is consistent with the City's objectives. Regardless of what financing structure(s) is utilized, due-diligence review must be performed for each transaction, including the quantification of potential risks and benefits, and analysis of the impact on City creditworthiness and debt affordability and capacity. Because fixed rate debt transfers most financial risks to bondholders, fixed rate debt should be considered the preferred method of financing long-term capital needs. Therefore, while permitted for consideration, the following instruments are disfavored:
  - **Variable Rate Debt**

    Variable rate debt affords the City the potential to achieve a lower cost debt depending on market conditions. However, the City shall seek to limit the use of variable-rate debt due to the potential risks of such instruments.
    - **Purpose**

      The City may consider the use of variable rate debt for the purposes of:
      - Reducing the costs of debt issues.
      - Increasing flexibility for accelerating principal repayment and amortization (often variable rate debt may be prepaid without penalty).
      - Enhancing the management of assets and liabilities (matching short- term "priced debt" with the City's short-term investments).
      - Diversifying interest rate exposure.
      - As a short-term source of construction or acquisition financing, (i.e., commercial paper, to reduce interest cost).
    - **Considerations and Limitations on Variable-Rate Debt**

      The City may consider the use of all alternative structures and modes of variable rate debt to the extent permissible under State law and shall make determinations among different types of modes of variable-rate debt based on cost, benefit, and risk factors. The Chief Financial Officer shall consider the following factors in considering whether to recommend variable rate debt:
      - Any long-term issuance of variable rate debt should not exceed twenty percent (20%) of total City General Fund supported debt.
      - Any long-term issuance of variable rate debt should not exceed the current unrestricted General Fund reserve levels.
      - Whether interest cost and market conditions (including the shape of the yield curves and relative value considerations) are unfavorable for issuing fixed rate debt.
      - The likelihood of projected debt service savings when comparing the cost of fixed rate bonds.
      - Costs, implementation and administration are quantified and considered.

- Cost and availability of liquidity facilities (lines of credit necessary for variable rate debt obligations and commercial paper in the event that the bonds are not successfully remarketed) are quantified and considered.
- The ability to convert debt to a fully amortizing fixed rate or the permissibility to redeem at par at any time.
- The findings of a thorough risk management assessment.

▪ **Risk Management**

Any issuance of variable rate debt shall require a rigorous risk assessment, including, but not limited to factors discussed in this section. Variable rate debt subjects the City to additional financial risks (relative to fixed rate bonds), including interest rate risk, tax risk, and certain risks related to providing the necessary liquidity required for variable rate debt.

The City shall properly manage risks associated with variable rate debt as follows:

- **Interest Rate Risk and Tax Risk** – The risk that market interest rates increase on variable-rate debt because of market conditions, changes in taxation of municipal bond interest, or reductions in tax rates. Mitigation – Limit total variable rate exposure per the defined limits and match the variable rate liabilities with short-term assets.
- **Liquidity/Remarketing Risk** – The risk that holders of variable rate bonds exercise their "put" option, tender their bonds, and the bonds cannot be remarketed requiring the bond liquidity facility provider to repurchase the bonds. This will result in the City paying a higher rate of interest to the facility provider and the potential rapid amortization of the repurchased bonds.
- **Mitigation** - Limit total direct variable-rate exposure. Seek liquidity facilities, which allow for longer (5-10 years) amortization of any draws on the facility. Secure credit support facilities that result in bond ratings of the highest short-term ratings and long-term ratings not less than AA. If the City's bonds are downgraded below these levels as a result of the facility provider's ratings, a replacement provider shall be sought.
- **Liquidity/Rollover Risk** – The risk that arises due to the shorter term of most liquidity provider agreements (1-5 years) relative to the longer-term amortization schedule of the City's variable-rate bonds. In particular, (1) the City may incur higher renewal fees when renewal agreements are negotiated and (2) the liquidity bank market constricts such that it is difficult to secure third party liquidity at any interest rate.
- **Mitigation** – Negotiate longer terms on provider contracts to minimize the number of rollovers.

REFUNDING GUIDELINES

- The Chief Financial Officer shall monitor at least annually all outstanding City debt obligations for potential refinancing opportunities. The City should consider refinancing of outstanding debt to achieve annual savings. Absent a compelling economic reason or financial benefit to the City, any refinancing should not result in any increase to the weighted average life of the refinanced debt.
- The City will generally seek to achieve debt service savings that on a net present value basis are at least three percent (3%) of the current debt being refinanced. Any potential refinancing executed more than ninety (90) calendar days in advance of the outstanding debt optional call date shall require at least a three percent net present value savings threshold. If there is negative arbitrage in an advance refunding, the interest efficiency should at least be fifty percent (50%). Under any savings scenario, the net present value assessment shall factor in all costs, including the total cost of issuance, escrow, and foregone interest earnings of any contributed funds on hand. Any potential refinancing shall additionally consider whether an alternative refinancing opportunity with higher savings can be reasonably expected in the future.
- Consideration of this method of refinancing shall place greater emphasis on determining whether an alternative refinancing opportunity with higher savings is reasonably expected in the future.

COMMUNICATION, ADMINISTRATION AND REPORTING, AND INTERNAL CONTROL PROCEDURES

- **Rating Agency Relations and Annual or Ongoing Surveillance** – The Chief Financial Officer shall be responsible for maintaining the City's relationships with Standard & Poor's Ratings Services, Fitch Ratings and Moody's Investor's Service. The City is committed to maintaining or improving its existing rating levels. In addition to general communication, the Chief Financial Officer shall:
  - Ensure the rating agencies are provided updated financial information of the City as it becomes publicly available.
  - Communicate with credit analysts at each agency at least once each year, or as may be requested by the agencies.
  - Prior to each proposed new debt issuance, schedule meetings or conference calls with agency analysts and provide a thorough update on the City's financial position, including the impacts of the proposed debt issuance.
- **Council and Finance Commission Communication** – The Chief Financial Officer should report feedback from rating agencies to the City Council and/or Finance Commission, when and if available, regarding the City's financial strengths and weaknesses and recommendations for addressing any weaknesses as they pertain to maintaining the City's existing credit ratings.
- **Debt Issue Record-Keeping** – A copy of all debt-related records shall be retained at the City's offices. At minimum, these records shall include all official statements, bond legal documents/transcripts, resolutions, trustee statements, leases, and title reports for each City financing (to the extent available).
- **Compliance** - When issuing debt, in addition to complying with the terms of this Policy, the City shall comply with any other applicable policies regarding initial bond disclosure, continuing disclosure, post-issuance compliance, and the investment of bond proceeds in accordance with applicable bond indentures concerning tax compliance with tax

exempt bonds. Without limiting the generality of the foregoing, the City shall periodically review the requirements of and will remain in compliance with the following:

- **Continuing Disclosure** – The City shall comply with federal securities law, including any continuing disclosure undertakings entered into by the City in accordance with Securities and Exchange Commission Rule 15c2-12. The City shall file its annual financial statements and other financial and operating data for the benefit of its bondholders as required in any such agreement for any debt issue. The City shall maintain a log or file evidencing that all continuing disclosure filings have been timely made.
- **Arbitrage Rebate** – The use of bond proceeds and their investments shall be monitored by the Chief Financial Officer to ensure compliance with all Internal Revenue Code Arbitrage Rebate Requirements. The Chief Financial Officer shall ensure that all bond proceeds and investments are tracked in a manner that facilitates accurate calculation; and, if a rebate payment is due, such payment is made in a timely manner.
- **Annual Reporting** – California Government Code Section 8855(k), or any successor statute, and the annual reporting requirements therein.
- **Other Compliance** - Other compliance requirements imposed by regulatory bodies.

Comprehensive post-issuance policies are listed in Appendix A.

- **Proceeds Administration** - Proceeds of debt will be held either (a) by a third-party trustee or fiscal agent, which will disburse such proceeds to or upon the order of the City upon the submission of one or more written requisitions by the City Manager (or his or her written designee), or (b) by the City, to be held and accounted for in a separate fund or account, the expenditure of which will be carefully documented by the City. On a quarterly basis, the Chief Financial Officer (or his or her designee) shall monitor the proceeds and the disposition of unexpended proceeds.

CREDIT RATINGS

- The City shall consider published ratings agency guidelines regarding best financial practices and guidelines for structuring its capital funding and debt strategies to maintain the highest possible credit ratings consistent with its current operating and capital needs.

LEGAL DEBT LIMIT

- Huntington Beach City Charter Section 610 provides that “The City shall not incur an indebtedness evidenced by general obligation bonds which shall in the aggregate exceed the sum of 12 percent of the total assessed valuation, for purposes of City taxation, of all the real and personal property within the City.” While this limit defines the absolute maximum legal debt limit for the City, it is not an effective indicator of the City’s affordable debt capacity.

AFFORDABILITY

- Prior to the issuance of debt to finance a project, the City shall carefully consider the overall long-term affordability of the proposed debt issuance. The City shall not assume more debt without conducting an objective analysis of the City’s ability to assume and support additional debt service payments. The City shall consider its long-term revenue and expenditure trends, the impact on operational flexibility and the overall debt burden on the tax payers. The evaluation process shall include a review of generally accepted measures of affordability and will strive to achieve and or maintain debt levels consistent with its current operating and capital needs.

- **General Fund-Supported Debt –** General Fund Supported Debt generally include Certificates of Participation ("COPs") and Lease Revenue Bonds ("LRBs") which are lease obligations that are secured by an installment sale or by a lease-back arrangement between the City and another related public entity. The general operating revenues of the City are pledged to pay the lease payments, which are, in turn, used to pay debt service on the LRBs or COPs. These obligations do not constitute indebtedness under the state constitutional debt limitation and, therefore, are not subject to voter approval.

  Payments to be made under valid leases are payable only in the year in which use and occupancy of the leased property is available, and lease payments may not be accelerated. Lease financing requires the fair market rental value of the leased property to be equal to or greater than the required debt service or lease payment schedule. The City as lessee is obligated to place in its Annual Budget the rental payments that are due and payable during each fiscal year the City has use of the leased property.

  The City should strive to maintain its net General Fund-backed debt service at or less than eight percent (8%) of annually budgeted General Fund revenue. This ratio is defined as the City's annual debt service requirements on COPs and LRBs compared to total General Fund Revenues. This ratio, which pertains to only General Fund backed debt, is often referred to as "lease burden."

- **Revenue Bonds** – Long-term obligations payable solely from specific pledged sources, in general, are not subject to a debt limitation. Examples of such long-term obligations include those which achieve the financing or refinancing of projects provided by the issuance of debt instruments that are payable from restricted revenues or user fees (Enterprise Revenues) and revenues generated from a project.

  In determining the affordability of proposed revenue bonds, the City shall perform an analysis comparing projected annual net revenues from pledged sources to estimated annual debt service on revenue bonds. The City should strive to maintain a debt service coverage ratio of at least 125% using historical and/or projected net revenues to cover annual debt service for bonds. The City may require a revenue rate increase or reduce operating costs so that revenues cover both operations and debt service costs, and create debt service reserve funds to maintain the required coverage ratio.

- **Special Districts Financing** – The City's Special Districts primarily consist of Community Facilities Districts ("CFDs"). The City may consider requests for Special District formation and debt issuance when such requests address a public need or provide a public benefit. Each application shall be considered on a case-by-case basis as long as the City assumes no obligation under, or in connection with, such debt issuance. The Finance Department shall not recommend a financing if it is determined that the financing could be indirectly detrimental to the financial standing of the City or such financing would otherwise not be in the best interests of the City.

- **Conduit Debt –** Conduit financing provides for the issuance of securities by a government agency to finance a project of a third party, such as a non-profit organization or other private entity. The City may sponsor conduit financings for those activities that have a general public purpose and are consistent with the City's overall service and policy objectives. Unless a compelling public policy rationale exists, such conduit financings will not in any way obligate the City or otherwise pledge the City's faith and credit.

APPENDIX A

POST ISSUANCE COMPLIANCE POLICY AND PROCEDURE MANUAL

PURPOSE

- The purpose of this post-issuance compliance policy and procedure manual is to adopt policies and procedures to guide the City in meeting the requirements of the Internal Revenue Code of 1986, as amended, and Treasury Regulations (the "Tax Code") concerning tax-exempt and tax-advantaged debt ("debt issuances"). Non-compliance with the Tax Code may result in fines and/or loss of the preferential status of the debt issuances.

  The Finance Department will be primarily responsible for ensuring that the City successfully carries out its post-issuance compliance requirements under applicable provisions of the Tax Code with regard to all debt issuances of the City. The Finance Department shall be assisted by other City staff and officials when appropriate. The Finance Department will also be assisted in carrying out post-issuance compliance requirements by contracted entities including Bond Counsel, Municipal Advisor, Paying Agent, Trustee, Arbitrage Consultant, and/or other consultants deemed necessary.

  The Finance Department shall be responsible for assigning post-issuance compliance responsibilities to other City staff, Bond Counsel, the Municipal Advisor, the Paying Agent, the Trustee and the Arbitrage Consultant. The Finance Department shall utilize such other professional service organizations as are necessary to ensure compliance with the post-issuance compliance requirements of the City.

GENERAL OVERVIEW OF ARBITRAGE, YIELD RESTRICTION AND REBATE REQUIREMENTS

- **Overview**

  The purpose of this section is to introduce the concept of arbitrage and its requirements. There are exceptions to many of the arbitrage rules. Advice from the City's Arbitrage Consultant and/or Bond Counsel is strongly recommended before any action is taken.

- **Definition**

  Arbitrage is the price differential, or profit made, from investing inherently lower yielding debt issuance proceeds in higher yielding taxable investments. Arbitrage is the difference between the yield on an issuer's debt issuance and the investment income earned on the proceeds invested in taxable instruments. Arbitrage rebate refers to the positive or negative amount that must be paid (rebated) to the federal government.

- **Areas of arbitrage compliance that must be addressed:**
  - The arbitrage rebate requirements identify what must be done with any arbitrage (profits or earnings) above the debt issuance's yield earned on the investment of the gross proceeds of the debt issuance. Arbitrage on gross proceeds must be rebated to the federal government every five years after the date of issuance (or earlier if elected) through and including the final maturity ("filing date").
  - The yield restriction requirements set forth various investment yield limitation conditions for different categories of gross proceeds from a debt issuance (e.g. construction, refunding escrow, debt service, and reserve funds). The issuer should meet these various yield restriction conditions to avoid compromising the tax-exempt or tax-advantaged status of the debt issuance. Since the yield

restriction requirements are specific to a debt issuance it is recommended that the City consult with the Arbitrage Consultant and/or Bond Counsel to determine the specific yield restriction requirements on a per debt issuance basis.

Construction Fund Yield Restriction: The most common yield restriction constraint for an issuer is related to construction funds. Generally, if there are unexpended project/construction proceeds at the end of the initial 3-year temporary period in excess of the minor portion (the lesser of $100,000 or 5% of the sale proceeds of the debt issuance), an issuer may no longer invest the remaining proceeds above the materially higher yield (debt issuance yield + .125%) without taking corrective actions to remedy interest earnings above the materially higher yield. The issuer must yield restrict the proceeds below the materially higher yield, or a yield reduction payment report will be required. Any yield reduction payment under the yield restriction requirements must be paid per the same deadlines as the arbitrage rebate requirements: every five years after the date of issuance (or earlier if elected) through and including the final maturity.

- **Purpose of the Tax Code regarding arbitrage:**
  - The Tax Code was put into place to minimize the benefits of investing tax-exempt or tax-advantaged debt proceeds, thus encouraging expenditures for the governmental purpose of the debt issuance and to remove the incentive to:
    - Issue debt earlier than needed,
    - Leave debt outstanding longer than necessary, and/or
    - Issue more debt than necessary for a governmental purpose.
- **Type of debt issuances and funds subject to arbitrage compliance:**
  - The following types of debt issuances are subject to arbitrage compliance as of the following dates:
    - Single Family Debt Issuances 09/25/79
    - Private Activity Debt Issuances 12/31/84
    - Student Loan Debt Issuances 12/31/85
    - Governmental Debt Issuances 08/31/86
  - The following funds and proceeds of a debt issuance are defined as Gross Proceeds of a debt issuance:
    - Project funds
    - Debt service funds
    - Costs of issuance funds
    - Refunding escrow funds
    - Reserve funds
    - Disposition proceeds
    - Replacement proceeds (other than debt service funds)
    - Transferred proceeds (if an old debt issuance has been refunded by a new debt issuance and the old debt issuance has unspent funds, such funds may transfer to the new debt issuance)

  Note of Concern**:** An often misunderstood concept is that monies received upon closing of a debt issuance are the only monies subject to arbitrage rebate. One of the most common funds found to be subject to arbitrage rebate that is not funded from debt issuance proceeds is the debt service fund. The debt service fund receives a majority of its funding from tax or use revenues. The debt service fund is required to be included in the arbitrage rebate calculation unless the fund balance is depleted at least once each bond year, except for a reasonable carryover amount not to exceed the greater of:

- The earnings on the fund for the immediate preceding bond year; or
- One-twelfth of the principal and interest payments on the Debt Issuance or the immediately preceding bond year.

- **Exceptions to the rebate requirements:**

The Tax Code sets forth general arbitrage and rebate requirements for debt issuances. The general rule is that any arbitrage earned must be determined and reported to the federal government every fifth anniversary date after the date of issuance of the debt issuance and on the final maturity, or as elected. Arbitrage rebate is essentially 100% of investment earnings in excess of the debt issuance's yield. There are several exceptions to the arbitrage and rebate requirements, and if any one of these exceptions are met, all or a portion of the debt issuance's proceeds are not subject to the arbitrage and rebate requirements. Consult with the City's Arbitrage Consultant and/or Bond Counsel to determine if the debt issuance is eligible for a particular exception, to establish the appropriate investment plan for the debt issuance proceeds, and to assess whether the exception requirements were met.

The purpose of this section is to introduce the concept of spending exceptions and their requirements. There may be special elections and circumstances for a debt issuance that can affect how the exceptions are tested. Advice from the City's Arbitrage Consultant and/or Bond Counsel is strongly recommended before any action is taken. Below are descriptions of the various exceptions:

- 6-month spending exception: If all gross proceeds and actual interest earnings are spent within 6-months after issuance, the interest earned during that period is not subject to the rebate requirements. Intermediate expenditure requirements are necessary (95% by 6 months and 100% within 12 months).

  If there are unspent proceeds remaining at the end of the 6-month period, an issuer may still qualify for the spending exception under the following condition:

  - If the remaining amount is 5% or less and is spent within 6 months from the end of the 6-month spending date.
- 18-month spending exception: If a debt issuance does not qualify as a construction issuance (75% of the debt issuance actually spent on construction) then the debt issuance is eligible for the 18-month spending exception, but not the 2-year spending exception. If all gross proceeds and expected interest earnings for the 6-month and 12-month period and actual interest for the 18-month period is spent within 18-months according to a strict timetable, the interest earned during that period is not subject to the rebate requirements. Intermediate expenditure requirements are necessary (15% by 6 months, 60% by 12 months, 100% by 18 months.

If there are unspent proceeds remaining at the end of the 18-month period, an issuer may still qualify for the spending exception under the following conditions:

- A reasonable retainage amount of 5% or less is allowed for business purposes and the retainage is spent within 12 months from the end of the 18-month spending date, or;
- If the remaining amount does not exceed the lessor of $250,000 or 3% of the issue price and due diligence is exercised to complete the project and spend the remaining project/construction proceeds.

▪ 2-year spending exception: If a debt issuance qualifies as a construction issuance (75% of the debt issuance is actually spent on construction) and all gross proceeds and expected interest earnings for the 6-month, 12-month, and 18-month period and actual interest for the 24-month period are spent within 2 years according to a strict timetable, then interest earned during that period is not subject to the rebate requirements. Intermediate expenditure requirements are necessary (10% by 6 months, 45% by 12 months, 75% by 18 months and 100% by 2-years).

If there are unspent project/construction proceeds remaining at the end of the 2-year period, an issuer may still qualify for the spending exception under the following conditions:

- A reasonable retainage amount of 5% or less is allowed for business purposes and the retainage is spent within 12 months from the end of the 2-year spending date, or;
- If the remaining amount does not exceed the lessor of $250,000 or 3% of the issue price and due diligence is exercised to complete the project and spend the remaining project/construction proceeds.

▪ Small issuer exception: General taxing authorities reasonably expecting to issue $5M or less in tax-exempt or tax-advantaged debt during each calendar year (cumulative for all debt issuances) may qualify for the small issuer exception to the rebate requirements, but must still satisfy the yield restriction requirements. The small issuer exception does not apply to private activity, 501(c)(3) or student loan debt.

- General requirements:
  - The issuer must have general taxing powers.
  - The debt issuances must be governmental debt issuances.
  - At least 95% of the proceeds must be used for local governmental activities of the issuer or by governmental units located within the issuer's boundaries.
  - All tax-exempt or tax-advantaged debt issued in a calendar year cannot exceed $5,000,000.
- Additional requirements for refunding debt issuances:
  - The debt being refunded (old debt issuance) must have qualified for the small issuer exception.
  - The weighted average maturity of the refunding debt issuance (new debt issuance) must not exceed the weighted average maturity of the refunded debt (old debt

issuance). Current refunding debt issuances that have a three year or less weighted average maturity are exempt from the weighted average maturity test.

- The refunding debt (new debt issuance) must not mature more than thirty years after the issuance of the original refunded debt (old debt issuance).

Note – Historically 1/3 of refunding debt issuances (new debt issuances) will fail one of the three rules listed above and become subject to the rebate requirements.

DUE DILIGENCE REVIEW AT REGULAR INTERVALS

- This policy and its related procedures start with a review of the due diligence measures that will take place at regular intervals, as well as each filing date to ensure that each debt issuance is compliant with the requirements of the Tax Code. The City will complete the annual due diligence review on all debt issuances.

RETENTION OF ADEQUATE RECORDS TO SUBSTANTIATE COMPLIANCE

- **General overview**
  - Debt not refunded: Currently the IRS record retention requirements are to keep all records, data and documents associated with non-refunded debt issuances for three years past the final maturity date for the debt issuance (or longer if required by local or state law.)
  - Refunded debt: Since the refunding debt issuance (new debt issuance) is dependent on the tax-exempt or tax-advantaged status of the refunded debt issuance (old debt issuance), all records are required to be maintained for three years past the final maturity of both debt issuances (or longer if required by local or state law).
  - Electronic data storage requirements**:** Electronic records may be stored in an electronic format in lieu of hard copies if certain requirements are satisfied, for example:
    - The system must ensure an accurate and complete transfer of the hard copy books and records to the electronic storage system and contain a retrieval system that indexes, stores, preserves, retrieves and reproduces all transferred information.
    - The system must include reasonable controls and quality assurance programs.
    - The information maintained in the system must be cross-referenced with the books and records in a manner that provides an audit trail to the source documents.
    - Upon request by the IRS, a complete description of the electronic storage system, including all procedures relating to its use and the indexing system must be provided.
    - Upon request by the IRS, the issuer must retrieve and reproduce hard copies of all electronically stored records.
    - The system must not be subject to any agreement that would limit the IRS' access to the use of the system.

- **Electronic file storage and backup**: Financial/accounting transactions will be retained in a designated computer file folder within G:\FINANCE DEPARTMENT\ACCOUNTING and will be backed up by the Information Services Department. Access to this folder will be restricted to Finance Department staff.
- **Storage of hard copies:** A folder jacket, box or other media storage container displaying the debt issuance description will be set up for each debt issuance. The storage container will contain the documents mentioned in Section E on the next page. Access will be restricted to persons authorized by the Finance Department.
- **Destruction of records:** A log will be kept of all debt issuances whose records are destroyed after the IRS mandated retention period detailing the debt issuance description, allowable destruction date, date records were destroyed, the Finance Department's signature authorizing the record destruction, and witness signature. Access to this information will be restricted as authorized by the Finance Department.
- **Required information to be stored for each debt issuance**
  - Documents: Bond Counsel shall send a Transcript for the debt issuance to the Finance Department. If a Transcript was not compiled, then copies of the following documents will be forwarded or made available to the Finance Department's office:
    - Bond Counsel Opinion
    - Final Official Statement or Private Placement Memorandum
    - Insurance Documents
    - Council Certificate for Ordinance
    - Copy of Ordinance Authorizing Debt Issuance
    - IRS Form 8038-G, Form 8038-GC, Form 8038, Form 8308-TC or Form 8038-B
    - CPA Verification Report (for refunding debt issuances only)
    - Non-Arbitrage Tax Certificate or similar document
    - All Debt Service Schedules not included in the Official Statement
    - Letter of Credit Agreement (generally for variable rate debt issuances only)
    - Swap Agreement (generally for variable rate debt issuances only)
    - Winning Bid Forms
    - Trust Indenture
    - Investment Banker's Closing Memorandum
    - Investment Banker's Notice of Delivery Memorandum
    - Investment Banker's Sources and Uses of Funds Memorandum
  - Reports completed after issuance
    - Rebate calculation reports
    - Yield restriction reports
    - Spending exception reports
    - Penalty in lieu of rebate reports
    - CPA verification report for restructuring of escrow
    - Payment documentation to include:
      - Form 8038-T
      - Cancelled check

        - Proof of mailing
    - Refund claims
    - Other reports related to the Debt Issuance
- Correspondence
    - Bond Counsel
    - Board Meetings
    - Municipal Advisor
    - Arbitrage Consultant
    - Underwriter
    - Investment Firms
    - Other correspondence concerning any other aspect of the debt issuance to include but not limited to expenditures, investments, allowable projects, etc.
- Investment activity: Trust statements (or equivalent) with detailed investment activity for the entire computation period for each fund/account in which gross proceeds of the debt issuance were held. Investment information must be recorded on a daily transactional level. This information is required to compute the yield on the investments and to comply with archive requirements. Investment activity details should include such items as:
    - General ledgers
    - Subsidiary ledgers
    - Investment statements (state pools, bank statements, etc.)
    - Type of investment
    - Date of purchase and purchase price
    - Interest rate
    - Interest payment amounts
    - Maturity date
    - Interest payment dates
    - Interest calculation methodology
    - Date of sale and sales price
    - Investment contract information to include:
        - Evidence of the purchase price paid for investment contract
        - Detailed documentation of the investment contract bid process
        - Certification by the investment contract provider of fees paid for contract
        - All bid solicitation forms (3 bid minimum)
        - Administrative costs
- Expenditure information: The Finance Department will capture expenditure information. The following expenditure information must be captured and stored in accordance with the above mentioned record retention requirements to include:
    - Description of expenditure
    - Date of expenditure

    - Amount of expenditure
    - Invoices
    - Proof of payment (canceled check, wire information, etc.)
- Initial letter of credit information to include:
    - Payment amounts
    - Date of payment
    - Terms
- Actual letter of credit information to include:
    - Actual amount paid
    - Actual date payment is made
    - Invoices
    - Statements
- Allocation of gross proceeds to expenditures: Any allocation of gross proceeds to expenditures must involve a current outlay of cash for the governmental purpose of the debt issuance. A current outlay of cash is an outlay reasonably expected to occur within five banking days after the date of an allocation. If expenditure is paid by check, the outlay is the date the check is mailed, provided that it is expected to be cashed in five days.
    - Allocation: Reasonable allocation methods for allocating funds from different sources to expenditures for the same governmental purpose include any of the following methods if consistently applied:
        - The first in, first out/FIFO method permits the City to put the proceeds of more than one debt issuance into a single account (commingle) and treat all expenditures as coming from proceeds of the first debt issuance until they are fully spent.
        - The gross proceeds spent first method is used where available funds include, tax revenues, private contributions, etc., in addition to debt issuance proceeds. The debt issuance proceeds are treated as spent first.
        - The specific tracing method permits the City to keep proceeds from different debt issuances in separate accounts. Costs may be charged to any debt issuance/checking account at the City's discretion.
        - The ratable allocation method permits the City to place proceeds of more than one debt issuance into a single account (commingle) and treat expenditures as coming from proceeds of each debt issuance that contributed proceeds to that account. The expenditures are allocated to each debt issuance ratably based on each debt issuance's proportion of ownership of the account.
    - Timing: An issuer must account for the allocation of proceeds to expenditures not more than 18 months after the later of: the date the expenditure is paid or the date the project, if any, that is financed by the debt issuance is placed in service. This allocation must be made in any event by the date 60 days after the fifth anniversary of the issuance date or

the date 60 days after the retirement of the debt issuance, if earlier. This paragraph applies to debt issuances issued on or after May 16, 1997.

- Allocation of investments in a commingled fund: The Tax Code requires that all payments and receipts on investments held in a commingled fund must be allocated to the different sources/investments in the fund not less frequently than the close of a consistently used fiscal period (not in excess of three months); this allocation must be based on a consistently applied, reasonable ratable allocation. Treasury Reg. Section 1.148-6(e). Currently, the City allocates all payments and receipts monthly.
- Qualified use of proceeds, financed property, private business use: The qualified use of proceeds, property financed, and private business use limitations by the debt issuance should be identified and continually monitored to ensure compliance with the limitations as defined in the debt issuance documents or if more restrictive, state law or the Tax Code's limitations. Supporting documentation is required to support qualified use of proceeds, property financed, and private business use. The Finance Department will ensure such limitations are in compliance with debt issuance documents or if more restrictive, state law or the Tax Code's limitations.
- Issuance price and volume cap allocation: The issuance price and volume cap allocation activity limitations should be identified and monitored to ensure compliance with the limitations as defined in the debt issuance documents or if more restrictive, state law or the Tax Code's limitations. Supporting documentation is required for issuance price determination and volume cap allocation limitations of the debt issuance. The Finance Department will ensure such limitations are in compliance with the debt issuance documents or if more restrictive, state law or the Tax Code's limitations.
- Fair market value of investments: The City is to provide information to support that the investments were purchased or sold at a fair value. The City may not purchase an investment at a price in excess of fair market value with gross proceeds of the debt issuance. Nor may the City sell an investment purchased with gross proceeds at a price lower than fair market value. Treasury Regulations Section 1.148-6(c). In dealing with fair market value requirements, the Tax Code specifically provides three safe harbor categories of investments:
  - Securities traded on an established market from a willing seller in a bona fide arm's-length transaction.
  - Certificates of deposit purchased using a safe harbor under the applicable Tax Code. The safe harbor is available only for certificates that have a fixed interest rate, a fixed payment schedule and a substantial penalty for early withdrawal.
  - Guaranteed investment contracts purchased used a three-bid safe harbor under the Tax Code.
- Continuing disclosure: The City is to provide continuing disclosure, such as annual financial information and material event notices in accordance with SEC rule 15c2-12. The Finance Department is primarily responsible for undertaking such continuing disclosure obligations and to monitor compliance with such obligations.

PROCEDURES TO CORRECT NON-COMPLIANCE

- If it is determined that the requirements of the policies and procedures set forth herein have been violated or if it is determined that the Tax Code related to each debt issuance has been violated, the City will take the appropriate action described under the applicable Tax Code to remediate such non-compliance.
- Such action may include, but is not limited to the following steps:
  - Notify Finance Department.
  - Notify Bond Counsel, Arbitrage Consultant, and/or Municipal Advisors.
  - Resolve non-compliance in a timely manner in order to reduce penalties and late interest. A 60-day resolution period is recommended.
  - Take the appropriate remedial action as advised by Bond Counsel. Remedies may include, but are not limited to:
  - Enter the Voluntary Closing Agreement Program (VCAP).
    - Pay all past due arbitrage rebate or yield restriction liabilities to the IRS to include a letter of explanation for late payment, late interest and/or penalties.
    - Correct non-compliance matter to ensure future compliance.