A Classic Public Finance Debate Takes on New Relevance

By John Rose, Senior Consultant

An age-old question has new relevance, ***should you negotiate or competitively bid your GO bond issue?*** It's become more relevant recently for three reasons:

(1) Because the Washington State Auditor's office has waded in with their opinion on the subject;

(2) Because the turmoil in the capital markets over the past 24 months has substantially affected the buyers and sellers (as well as the regulators) of tax-exempt debt in the United States.

(3) Finally, the creation of new vehicles such as Qualified School Construction Bonds has been a major change in the landscape.

Much discussion was generated with the recent publication of the Performance Audit of school bond sales by the Washington State Auditor's Office. I believe the Audit Report entitled "Opportunities for the State to Help School Districts Minimize the Costs and Interest Paid on Bond Debt" leaves much to be desired, but the topics raised are good ones and deserve a good discussion.

The "opportunities" in question turn out to be largely educational; State officials are urged to educate local school officials as to the benefits of bid sales and the potential costs of negotiated underwritings. The Auditor leans heavily on old GFOA recommendations that in essence suggest that a bond issuer should always use an independent FA (who will not be a candidate to underwrite the bonds) and almost always use "competitive" or "bid" sales instead of the negotiated process. That would be a real change for Washington school districts that have historically favored negotiated sales.

The report also uses a complicated statistical analysis, not replicable by me, to conclude that Washington school districts who sold bonds through the negotiated process in the years 2003-07 would have saved $44-$79 million if they had followed the GFOA recommendations.

The report inspired some good and thoughtful comments from the State Treasurer, who respected the audit's findings but noted that "lessons learned from 2003-07 may be hard to apply in today's more challenging markets", and that "school districts often use more complex debt structures to manage the tax loads their voters carry – which makes it harder for them to issue debt on a competitive basis."

So what do I think? Earlier in my career I worked with a wide range of Washington local governments, including many school districts large and small, sometimes as financial advisor, sometimes as underwriter.

Interest costs and issuance expenses are important, but they are usually not the most important measures of a financing's success. For a school district, for example, other measures might include:

- Did the District maximize the funds available for its project?
- Did projected and actual tax burdens fall within the figures expected by the voters?
- Do future payments ease the potential voter approval of future operating levies? (I have often felt that the best test of the success of a bond sale is the voters' approval of the next operating levy!)
- Do future payments ease the potential voter approval of future bonds or capital levies?

The method of selling bonds should be chosen on the basis of whether it enhances the chances of achieving the District's goals. The major benefit of the bid sale is its transparency and the possibility of increased competition in pricing the bonds. The major benefit of the negotiated sale is the increased control it can give a District over the outcomes of a bond sale.

The 1980's and 1990's saw many Washington school districts undertake their first major borrowings in years. For many, the negotiated sale process allowed important flexibility that made a difference in getting the desired outcomes. The negotiated sale could more easily be cancelled, rescheduled or restructured, and it lent itself to the fine-tuning to meet investor needs that also helped the District achieve its goals.

My view has changed in recent years. The combination of much higher assessed values, the State's Guarantee program for school districts, and stable markets meant that the benefits of negotiated sales could actually do little to help the larger districts control their tax rates. I recently recommended to several large districts that they make the bid sale their standard procedure for the future, and in fact they had very successful bid sales when they first used that tool.

But over the last 18 months, financial markets collapsed and it looked like the world was ending. For a while, I would not have wanted to test the market without an underwriter by my side.

Now the story is more complex; the market for standard school district bonds is as hot as I've ever seen it, and most districts could sell their bonds at bid sale and expect multiple and aggressive bids. However, districts are also dealing with unbelievable changes in their assessed value, making customized bond structures all the more useful. Some districts are selling tax-credit bonds (QSCB's), a bond for which no standard market exists. I am currently representing one district that is selling its QSCBs via a direct loan with a bank; no Official Statement required, although negotiating bank documents can be a pain.

Sadly, I believe there is no single right answer for the method of sale. It is always right, however, for a bond issuer to have thought clearly and thoroughly vetted its financial goals. It is also important for an issuer to clearly understand its relationship with its Financial Advisor and/or underwriter and to be prepared to hold its bond advisors accountable for the results when they fall short.