June 24, 1994
ILR 94-C

Senator Howard A. Stephenson
1038 East 13590 South
Draper UT 84020

Subject: School District Bonding

Dear Senator Stephenson:

As you requested, our office has conducted a review of the Utah School Districts Finance Cooperative, an affiliate of the Utah School Boards Association. Specifically, we examined the role of the cooperative in administering a financial subsidy program designed to reimburse member school districts for costs they incur issuing bonds to finance the construction of new schools. Overall, our review found no evidence of fraud or inappropriate activities. We commend the cooperative for seeking ways to reduce the costs school districts incur issuing bonds through the subsidy program. However, our review concluded that the cooperative could better protect the interest of member school districts through the introduction of more competition into the process of selecting a bond underwriter and legal counsel in the subsidy program. Our review also concluded that the decision of whether bonds are issued through the means of a negotiated sale or competitive bid sale is best determined at the district level and not by the cooperative. Due to the limited review conducted in our survey, a detailed analysis on the issuance costs and interest rates of bonds issued by school districts in conjunction with the subsidy program was not conducted.

The two most common methods used by school districts to bring bonds to market are a negotiated sale and a competitive bid sale. In a negotiated sale, fees and interest rates are negotiated between the issuer and underwriter. In a competitive bid sale, fees and interest rates are determined by sealed bids submitted from competing underwriters. The Finance Cooperative's current policy requires all school districts applying for a subsidy to issue bonds through a negotiated sale with an underwriter and law firm selected by the cooperative. When the subsidy fund was initially created, the Utah Finance Cooperative Board granted an exclusive underwriting arrangement to the investment banking firm and law firm that helped establish the subsidy fund.

Controversy has surrounded the exclusive arrangements granted by the cooperative. Critics object to the exclusive arrangements because they eliminate competition from the process of selecting underwriters and bond counsel and also because they prohibit school districts from using competitive bid sales. Concerns have been raised that the lack of competition in the subsidy program may result in participating school districts being charged higher issuance costs and higher interest rates on bonds than school districts not participating in the subsidy program. Some district officials refuse to participate in the subsidy program because they believe the exclusive arrangements violate competitive provisions contained in the state's procurement code and competitive provisions contained in their district's purchasing rules. Representatives from most of the investment banking firms we talked to indicated that increased competition would probably be in the best interest of school districts participating in the subsidy program because competitive practices usually result in lower fees and better interest rates.

Our review attempted to determine whether concerns raised over the exclusive arrangements are valid and whether the subsidy program serves the best interest of participating school districts. During the course of our review, we interviewed a number of superintendents and business administrators from school districts throughout the state. We also interviewed a number of representatives from investment banking firms, financial advisors, and other experts in municipal bond underwriting in and outside the state. Lastly, we reviewed provisions of the state's procurement code relating to the selection of professional services. The results of our review are outlined below.

Experts Advocate Competition In The Selection Process

Several investment bankers, school district administrators, and business authors advocate the use of competitive practices when issuing municipal bonds. Most of the investment bankers we talked to indicated that competitive practices should be used whether bonds are issued through a negotiated sale or a competitive bid sale. Most of the school district superintendents and business administrators we talked to, in and out of the cooperative, cited a preference for competitive practices as a means of protecting the district and obtaining lower interest rates on their bonds. A number of articles have appeared in national business publications advocating that issuers of municipal bonds use competitive practices in the process of selecting financial advisors, underwriters, and bond counsel. Based upon our research and discussions with experts in the municipal bond industry, we have concluded that the best way for school district board members and administrative officials to protect the interest of their district when issuing bonds is through the use of competitive practices in the selection of financial advisors, underwriters, and bond counsel.

During our survey, we contacted a number of local investment bankers and financial advisors. Most indicated that the best way to safeguard the interest of school districts issuing bonds is through the use of competition. In their opinion, financial advisors, underwriters, and bond counsel, should be selected through a competitive process. They recommended forms of competition, like the request for proposal (RFP) process outlined in the state's procurement code. Most investment bankers felt the exclusive arrangements granted by the cooperative fail to foster competition. They believe the cooperative could better serve member districts by opening the selection process to more firms or by letting school districts select their own underwriters and bond counsel. Most felt the subsidy program could be improved if the exclusive arrangements did not exist.

At the end of our survey, officials from the School Boards Association pointed out that the local investment banking firms and financial advisors we contacted were all direct competitors of the firms granted the exclusive arrangements by the cooperative and were likely to have bias and prejudice against the subsidy program. In response to this criticism, we contacted investment bankers and financial advisors from outside the state that are not direct competitors in the Utah bond market. Each of the out-of-state investment bankers and financial advisors we contacted confirmed that the best way to ensure the protection of school districts issuing bonds is through the use of competitive practices. In addition, they expressed strong opposition to the concept of granting exclusive arrangements. The consensus of those contacted was that exclusive arrangements fail to provide an incentive for lower fees or better interest rates. One financial advisor stated, "exclusive arrangements are unhealthy, often leading to higher costs and lower quality of service."

It should be noted that none of the investment bankers we talked to advocated the sole use of either competitive bid sales or negotiated sales. Most agreed that each form of sale is a useful tool for bringing bonds to market. Each bond must be evaluated independently in order to determine which form of sale is best suited for the particular situation. Appendix A shows an information sheet used by one investment banking firm to help clients evaluate whether their bonds should be issued through a negotiated sale or a competitive bid sale. As seen in Appendix A, a number of factors such as market conditions, credit rating, size of the bond issue, and so on must be considered when determining how to bring bonds to market.

One district official we talked to stated, "Competition forces financial advisors, underwriters, and law firms to sharpen their pencils and offer districts the best possible deal because it is the only way they can get the district's business." He recommended that school districts introduce more competitive elements into the selection process whether issuing bonds through a negotiated sale or a competitive bid sale. Many of the district officials we talked to agree, indicating that it is difficult to argue against the value of competition in providing the lowest costs and best interest rates on bonds.

We also found a number of articles in business publications advocating the use of competitive practices in selecting underwriters and legal counsel. Some articles suggested that issuers of municipal securities, such as school districts, are relatively unsophisticated in the highly technical field of municipal bond underwriting and that the investment banking community sometimes takes advantage of that fact. The articles we read indicated that issuers can help level the playing field through the use of competition and recommend that issuers let the competitiveness of the marketplace work to their advantage. An article written for the Municipal Treasurers Association of US & Canada, by David V. Landes, President of Twenty First Century Municipals, Inc., suggests:

> *If you elect to issue at competitive sale, break down the barriers to competition. If you elect a negotiated sale, instill some competition in the selection process for an underwriter: regularly solicit ideas from a varied group of firms; let those firms know that they will be rewarded for providing you with ideas and service; use a "competitive-negotiated" sale process where you narrow the field to a few firms and award the securities to the one with the best terms set at a specific time. The economic forces of*

supply and demand are in your favor; the level of competitiveness in the market and the available information and technology will reward your constituency.

In our opinion, the Finance Cooperative would better serve member districts by introducing more competition into the process of selecting underwriters and legal counsel. It has been the experience of our office that competition promotes fair trade practices, lowers costs, and helps safeguard public entities. As a result, we recommend that the Utah School Districts Finance Cooperative Board develop means to introduce more competition into the process of selecting underwriters and bond counsel in the subsidy program. We also encourage the board to develop programs designed to instruct district officials on competitive practices designed to protect the district's interest. We recommend the board review the rules for competitive sealed proposals outlined in rule R33-3-2 **Utah Administrative Code** regarding the selection of professional services. Appendix "B" lists nine ways issuers of municipal bonds can introduce more competition into the selection process.

Some of the investment bankers we talked to emphasize that price or low bid should not always be the final determinant in selecting an underwriter. They stated that undercapitalized firms have submitted the lowest bid on bond issues. However, when problems have arisen five or ten years later, these firms were out of business and the issuer was left to deal with the problems. We agree with this observation and note that the Competitive Sealed Proposal process outlined in the state's administrative rules instructs that factors other than price can be considered in awarding contracts. Certainly factors such as underwriting experience, financial stability of the firm, and reputation of the firm in addition to other factors should be taken into consideration when selecting an underwriter.

Exclusive Arrangements Were Based On Loyalty

Finance Cooperative officials stated that the exclusive arrangements granted by the board were based on loyalty to the investment banking firm and law firm that helped create the subsidy program. In 1988, the Utah School Districts Finance Cooperative issued $200 million non-taxable bonds at 8.375% interest to form a hedge pool. The hedge pool was intended to assist member school districts in guarding against rising interest rates. Member districts could borrow from the pool if market interest rates rose above the pool's 8.375% rate. However, instead of rising, market interest rates fell and school districts could obtain lower interest rates on the open market than through the hedge pool. As a result, the $200 million hedge pool became essentially unusable. Then in 1991, an investment banking firm came up with an idea to utilize a portion of the hedge pool. They proposed that the cooperative replace (defease) approximately $53 million of the 8.75% non-taxable hedge pool bonds with $53 million 5.4% taxable bonds. The process reduced the interest rate on $53 million of the hedge pool bonds and changed their status from non-taxable to taxable. After a long and complicated process, the replacement (defeasance) was completed. Records show that the investment banking firm involved was paid over $1 million in fees for the replace-ment (defeasance) and subsequent re-marketings of the $53 million issue.

The replacement (defeasance) process also generated approximately $1 million in revenue for the cooperative. Of that amount, $600,000 was used to construct an administration building for the School Board Association and $400,000 was used to establish the subsidy fund. In addition, re-marketings of the $53 million taxable bonds will generate approximately $4.8 million for the subsidy fund over the next several years. Re-marketing is a term used to describe the refinancing of bonds in order to take advantage of lower interest rates. Figure I, shows the bond issues and subsidies awarded to each school district by the cooperative since the establishment of the subsidy program. As seen in Figure I, $1,132,638 in financial subsidies have been awarded to member school districts through 1993.

Following the creation of the subsidy fund, the Finance Cooperative Board established an administrative rule requiring all school districts applying for a subsidy to issue bonds through a negotiated sale with the investment banker and law firm responsible for the defeasance. Cooperative officials said the exclusive arrangements were granted on the basis of loyalty. They said the defeasance process was complex, time consuming, and somewhat risky for the firms involved. They also pointed out that if the investment banker had not come up with the idea for the defeasance, there would be no subsidy fund. As a result, the exclusive arrangements were granted as a reward.

Figure I
Financial Subsidies Awarded By
The Utah School Districts Finance Cooperative

Date	School District	Bond Issue	Subsidy Award
1991	Millard	$4,700,000	$100,000
1991	Cache	5,820,000	84,100
1991	North Sanpete	2,255,000	45,100

1992	Rich	2,200,000	44,000
1992	Millard	5,000,000	80,000
1992	Juab	2,000,000	44,500
1992	Ogden	6,050,000	85,250
1992	Grand	Grant	1,000
1993	Jordan*	84,400,000	79,500
1993	Jordan*	Same Issue	79,500
1993	South Summit	4,745,000	77,450
1993	Ogden	1,245,000	31,838
1993	Millard	4,000,000	50,000
1993	Cache	23,000,000	111,650
1993	Box Elder	28,500,000	113,750
1993	Provo	5,000,000	55,000
1993	Nebo	4,000,000	50,000
Total			**$1,132,638**

*** Total subsidy award is $477,000 to be paid in increments over two years.***

Some District Officials Are Uncomfortable With Exclusive Arrangements

Officials from some school districts we visited indicated they will not participate in the subsidy program because of the exclusive arrangements. They believe the lack of competition in the subsidy program may result in higher issuance costs and higher interest rates. They also believe the exclusive arrangements may violate competitive requirements contained in their district purchasing rules. Lastly, they are uncomfortable with the cooperative mandating how district's issue bonds, stating that the decision to issue bonds through a negotiated or competitive bid sale should be made by district officials and not by the cooperative. The controversy surrounding the cooperative and the subsidy program has divided the state's school districts into three groups: those opposed to the exclusive arrangements; those in favor of the exclusive arrangements; and districts with mixed feelings.

Critics Charge That School Districts May Pay Higher Issuance Costs And Higher Interest Rates Through The Subsidy. One criticism raised by district officials opposed to the subsidy program centers on issuance costs and interest rates. Issuance costs are the fees charged by underwriters, law firms, and others involved in preparing bonds to be sold on the open market. Interest rates are assigned to the various maturities of a bond by the underwriter. Bonds with higher interest rates are normally easier to sell; however, higher interest rates result in higher costs to the issuer. Critics charge that districts issuing bonds through the subsidy program may be paying higher issuance costs and higher interest rates than districts not participating in the subsidy program. They feel the lack of competition provides no incentive for the underwriter or law firm to offer lower fees or better interest rates. In their opinion, the subsidy may become a transfer back to the underwriter and law firm in the form of higher fees and higher interest rates.

We cannot confirm or deny whether districts issuing bonds through the subsidy program pay higher issuance costs or higher interest rates. Our office did not conduct an analysis to determine whether school districts issuing bonds in conjunction with the subsidy program pay the lowest possible issuance costs or receive the best possible interest rates because the expense associated with such an analysis was not justified for this limited survey. An analysis of this magnitude would require the assistance of an independent investment banking firm or other expert in the field of municipal securities. After discussing the possibility of such an undertaking with a number of investment bankers, we concluded that it would be extremely difficult if not impossible to find comparable bond issues. In order to make valid comparisons, bonds sales must be as close to the same date as possible because bond markets are volatile and subject to hourly changes. They also indicated that comparable issues are hard to find because of factors like credit rating, size, and bonding history unique to each issuer. Most investment bankers we talked to indicated that conclusions drawn from this type of analysis would be subject to considerable debate. Nevertheless, if legislative interest merits further investigation into this area, we will contract with an expert to act as consultant in a more detailed analysis of costs and interest rates on bonds issued through the subsidy program.

Our research also found that bond indexes do not provide a satisfactory means of comparing the sale of different bond issues because index reports are based on daily averages. The average reported by an index consists of a range of yields on select bond issues. While the price of a bond may be within the range reported by an index, it does not mean the bond was sold at the best possible price. Our review of the subsidy program found that, in most cases, school districts hire an independent financial advisor to negotiate discount rates and interest rates with the underwriting firm selected by the cooperative. Records show the financial advisor reports to district officials on how the sale of their bond compared with other bond sales of similar size on the same day.

The importance of school districts obtaining the best possible deal on the sale of their bonds can be demonstrated by examining how a small change in interest rates can result in a large difference in the total cost of a bond. From our discussions with investment bankers, we learned that interest rates can have a significant impact on the total cost of a bond. Figure II shows the difference in total cost associated with four different interest rates on a $6 million bond. The rates shown in Column (2) serve as the basis for comparison. Columns (3) through (5) show increases in the interest rates of five, ten, and twenty basis points. A basis point is equal to 1/100 of one percent---twenty basis points equals twenty one hundredths of a percent. The total interest cost associated with each rate is shown at the bottom of each column. As seen, total interest costs increase by $29,093; $58,185; and $116,370 with the corresponding increases of five, ten, and twenty basis points. This shows how slightly higher interest rates could result in significantly higher costs to school districts issuing bonds.

Figure II
Comparison of Total Costs with Different Interest Rates

(1) Principal Amount	(2) Interest Rate	(3) Increase by 5 Basis Points	(4) Increase by 10 Basis Points	(5) Increase by 20 Basis Points
$220,000	2.60%	2.65%	2.70%	2.80%
90,000	3.10	3.15	3.20	3.30
150,000	3.60	3.65	3.70	3.80
200,000	4.10	4.15	4.20	4.30
230,000	4.50	4.55	4.60	4.70
275,000	4.80	4.85	4.90	5.00
310,000	5.00	5.05	5.10	5.20
370,000	5.10	5.15	5.20	5.30
415,000	5.25	5.30	5.35	5.45
470,000	5.30	5.35	5.40	5.50
530,000	5.40	5.45	5.50	5.60
580,000	5.50	5.55	5.60	5.70
650,000	5.60	5.65	5.70	5.80
720,000	5.70	5.75	5.80	5.90
790,000	5.75	5.80	5.85	5.95
Total Cost:	$3,167,596	$3,196,689	$3,225,781	$3,283,966
Increase:		$29,093	$58,185	$116,370

Note: $6 million general obligation bond; Series 1992.
Maturities range from 1992 through 2006.

It should be noted that during the course of our audit we were provided with several studies prepared by school districts and investment banking firms comparing bonds issued through the subsidy program to bonds issued on the open market. The results of these studies showed that districts issuing bonds on the open market (competitive bid sales) receive lower costs and better interest rates than districts participating in the subsidy program. We asked a representative from a local investment banking firm to review the studies in order to determine whether the findings were valid. With the exception of one study, the investment banker concluded that the results of the studies were inconclusive. He explained that the differences in costs and interest rates could result from differences in the way the bonds were structured, differences in characteristics unique to each issuer, or changes in interest rates between the dates of sale. One study did appear reasonable; however, the investment banker thought additional information was needed on the method used to calculate the differences in interest rates before the study could be endorsed as being totally accurate. Based on this review and because the studies were not performed by our office, we did not feel comfortable showing the results of these studies in this report.

Representatives from the cooperative indicated that they routinely gather information on issuance costs from financial advisors, underwriters, and published indexes in order to monitor the issuance costs charged to districts participating in the subsidy program. However, they have not conducted studies comparing the interest rates received by districts participating in the subsidy program to districts not participating in the subsidy program. They felt the results of such comparisons would produce inconclusive results.

In our opinion, the question of greatest importance relating to how school districts issue bonds is whether school districts follow sound practices. We believe school district officials should follow guidelines that are designed to protect the district's interest when issuing bonds. We recommend that districts follow guidelines based on competitive practices. School district officials should not base the decision to issue bonds through a negotiated or competitive bid sale upon the receipt of a subsidy award. The means of sale should be determined with the assistance of a financial advisor and analysis demonstrating which form of sale is most advantageous to the district. District officials should seek to obtain the best possible deal on the sale of their bonds without regard to the subsidy program. The subsidy should only be considered after each district has obtained the best possible deal on the open market.

Some Feel Exclusive Arrangements Violate Purchasing Rules. Another concern is whether the exclusive arrangements violate competitive requirements contained in the state procurement code and district purchasing rules. The cooperative and their legal counsel indicated that they have reviewed the state's Procurement Code and Administrative Code and do not feel that the subsidy program violates those statutory and rule provisions. School district officials are divided over this issue. Some believe the exclusive arrangements violate both state and district rules. Others view the cooperative as a sole source provider and believe competitive purchasing requirements do not apply. Others are uncertain whether or not purchasing rules apply to the cooperative and the subsidy program. Attorneys we contacted were divided over the issue. Some indicated that the exclusive arrangements may violate the state's Procurement Code while others were uncertain.

In order to determine whether the Utah Procurement Code applies to the Finance Cooperative and whether the exclusive arrangements granted by the cooperative violate the Utah Procurement Code it will be necessary to obtain a legal opinion. We defer the question of legality to the Attorney General's Office and recommend that parties interested in these issues contact the Attorney General's Office. Likewise, we recommend that school district board members and administrators seek the advise of their legal counsel regarding this issue.

From a management perspective, however, it has been the experience of our office that public entities like the cooperative and school districts should seek to avoid affiliations and exclusive arrangements that might lead to inferences of impropriety or favoritism. The exclusive arrangements granted by the Finance Cooperative Board have already lead to criticism of the cooperative and the subsidy program. It is our opinion, that further criticism will result if the exclusive arrangements are maintained. The basic intent of the state procurement code and purchasing rules adopted by school districts is to promote open competition and eliminate suspicion of favoritism or one-sidedness in the awarding of contracts. Therefore, we recommend that the Finance Cooperative Board and school district officials avoid entering into exclusive arrangements and that they seek to promote fair and open competition in the awarding of contracts.

During our survey we learned that the procurement codes of some states contain specific language regarding competitive practices and the selection of financial advisors, underwriters, and bond counsel. In Utah, legislation may be needed to clarify the state's position on competitive practices pertaining to the selection of financial advisors, underwriters, and bond counsel by public entities.

Negotiated Sales May Not Always Result In The Best Deal For School Districts. Most of the investment bankers we talked to stated that school districts may not be getting the best possible deal if they are forced to always use a negotiated sale. They contend that each bond must be evaluated on its own merit in order to determine whether it should be brought to market through a negotiated or a competitive bid sale. They noted that competitive bid sales are often the preferred method. Some district officials complain that the cooperative's mandate that negotiated sales be used eliminates the option of competitive bid sales even though analysis may indicate that a competitive bid sale is in the best interest of the district. This forces district officials to choose between having the option of using competitive bid sales or participating in the subsidy program. District officials do not understand why they cannot receive a subsidy if analysis indicates that a competitive bid sale is in the best interest of the district.

We found that conflicts have occurred between district administrative officials and district school board members because of the cooperative's mandate that bonds be issued through a negotiated sale. Some business administrators and financial advisors stated that, at times, analysis has indicated that a competitive bid sale would be in the best interest of the district. However, school board members have voted to issue bonds through the subsidy program in order to show support for the cooperative and the School Board Association. Business administrators and financial advisors expressed frustration over this issue. They explained that the decision of how bonds are sold should be based strictly on analysis indicating which form of sale is best for the district---not on a desire to support the cooperative.

In our opinion, the decision to issue bonds through the means of a negotiated sale or a competitive bid sale should be made at the district level and not by the cooperative. We do not believe it is the role of the cooperative to mandate how districts bring bonds to market. The ultimate decision and responsibility for how bonds are issued rests with the school board members of each district. However, in making their decision, we believe school board members should carefully consider the advise and recommendations of business administrators, financial advisors, and other experts trained in the field of municipal securities.

At the end of our survey, School Board Association officials stated that they strongly object to the statements that school districts are "forced" or "mandated" to issue bonds through a negotiated sale. They stated that member school districts are entirely free to use whatever means they see fit to bring their bonds to market and that districts may choose to participate or not participate in the subsidy program. Obviously, school districts are not forced to participate in the subsidy program. However, as clearly stated in the cooperative's board minutes and administrative policy, school districts applying for a financial subsidy must issue bonds through the underwriter and bond counsel selected by the cooperative. This means, regardless of the terms used to describe the process, school districts participating in the subsidy program must issue bonds through a negotiated sale with the underwriter and bond counsel granted an exclusive arrangement by the cooperative. They have no choice. We emphasize that the decision of how bonds are brought to market should be made at the district level and not by the cooperative. If the cooperative wishes to administer a subsidy program, it should do so without attaching any conditions to the manner in which districts bring their bonds to market.

Guidelines For School Districts Issuing Bonds

Based on our discussions with investment bankers and other experts in the field of municipal bond underwriting and provisions contained in the Utah Procurement Code, we have developed the following guidelines for school district officials and board members to consider when issuing bonds.

Independent Financial Advisor: In most cases, school districts should use an independent financial advisor when issuing bonds. A financial advisor is a consultant to the issuer of municipal bonds who provides the issuer with advice with respect to the structure, timing, terms, and other similar matters concerning a new issue of bonds. The primary function of a financial advisor is to protect the interest of the issuer. Without the aid of a financial advisor, school districts run the risk of paying higher issuance fees or higher interest rates. Most investment bankers we talked to indicated that the benefit school districts receive from having a financial advisor outweigh the cost of hiring a financial advisor. The only instance where a financial advisor may not be needed is on an extremely small bond issue. In our opinion, a financial advisor is of utmost importance in safeguarding the interest of school districts issuing bonds.

One of the key functions of a financial advisor is assisting the issuer in determining whether bonds should be issued through the means of a negotiated sale or a competitive bid sale. The process of issuing a municipal bond is highly technical and complex. A financial advisor can assist in performing the analysis necessary to determine which manner of sale will be most advantageous to the issuer.

We recommend the use of competitive practices in the selection of a financial advisor. The selection process should be similar to the competitive sealed proposal process outlined in statute and rules. Some of the factors to be considered in selecting a financial advisor include: cost, expertise of the firm, financial stability of the firm, and the reputation of the firm. Some school districts reported that they have used the RFP process to retain a financial advisor for each bond issue. Other districts reported that they use the RFP process to retain a financial advisor for periods ranging from one to five years in order to avoid re-bidding for each bond issue.

We recognize that many school districts and other public entities have developed long-standing relationships with financial advisors, underwriters, and bond counsel. As a result, we recommend that all public entities review these arrangements in view of the recommendations contained in this report for increased competition as a means of protecting public interest when issuing bonds.

Negotiated Sales: If a financial advisor endorses a negotiated sale, we recommend that districts use competitive practices to select the underwriter and bond counsel they enter into the negotiated sale with. We recommend the selection process be similar to the competitive sealed proposal outlined in statute and rules. Qualifications of the underwriter and bond counsel should be based upon approximately the same criteria used to select a financial advisor (i.e. cost, experience, financial stability, reputation). Fees and interest rates can be negotiated between the underwriter and the issuer with assistance from the financial advisor acting in behalf of the issuer.

Competitive Bid Sales: If the district's financial advisor recommends that bonds be sold through a competitive bid sale, the competitiveness of the market ensures that the district receives the lowest fees and best interest rates from the competing firms. Bids are submitted by each competing firm. The contract is awarded to the firm submitting the lowest bid. The financial advisor can help determine whether the bids submitted are within the market. If all of the bids submitted are outside the market, the financial advisor may recommend that the issuer not accept any of the bids.

Recommendations:

1. We recommend that the Utah School Districts Finance Cooperative Board develop means to introduce more competition into the process of selecting underwriters and bond counsel in the subsidy program.

2. We recommend that school districts be allowed to determine, with the assistance of their financial advisor, the method of sale used to bring bonds to market.

3. We recommend that the Utah School Districts Finance Cooperative Board develop a policy which allows financial subsidy awards without regard to the manner by which districts sell their bonds.

4. We recommend that the Utah School Districts Finance Cooperative Board and all state school districts avoid entering into exclusive arrangements that might lead to inferences of impropriety or favoritism.

5. We recommend that the Utah School Districts Finance Cooperative Board develop programs to instruct district officials on competitive practices designed to protect the district's interest when issuing bonds.

6. We recommend that the Utah School Districts Finance Cooperative Board review the rules for competitive sealed proposals outlined in rule R33-3-2 **Utah Administrative Code** regarding the selection of professional services in developing guidelines and instructions for member school districts issuing bonds.

We hope this letter provides you with the information you need on this issue. A response letter from the Utah School District Finance Cooperative is included in this report. If you have any questions or need additional information, please let me know.

Sincerely,

Wayne L. Welsh
Auditor General

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Appendix A
Negotiated Versus Competitive Bid Sales

The issue of a negotiated versus competitive sale is frequently debated from issuer to issuer and investment banker to investment banker. Unfortunately, there are no simple clear cut answers as to when one option is more advantageous. Blind adherence to any course of action can result in a lack of wisdom. The market conditions, structure of issue, underlying security, credit ratings, frequency of offerings and other factors combine to indicate the wise course of action at any given time. In order to guide the decision, we have attempted to briefly explain the conditions supporting either method of bond issuance.

Negotiated Sale Is Generally Most Advantageous:

1. If there is a "story" to tell concerning the securities being offered e.g., dependence on local growth and development, public bonds particularly or wholly tied to private financing, uncommon redemption features, and complex structuring considerations;
2. If a longer offering period is necessary - certain bonds are primarily sold in the retail market, to either individuals or bonds funds, and require more time to saturate the retail market;
3. If interest rates show frequent changes and volatility;
4. If the issue is likely to attract few bids at a competitive sale because of a less than the highest credit rating or complex security features;
5. When used in advance refundings to most efficiently size and structure the maturity schedule and the escrow in accordance with the legally allowable escrow yield;
6. To allow the issuer flexibility to time the sale of bonds according to market conditions favorable to the bond issue, including interest rate trends, forward supply of bonds, level of institutional pre-sale and retail indications of interest;
7. To allow the issuer the option of credit enhancing only selected maturities to minimize net interest cost versus the entire issue depending on cost/benefit analysis;
8. If the issue is dependent on more than one market for optimizing cost (e.g., taxable government and tax-exempt monies);
9. If issuers want the flexibility to alter redemption features up to and including the date of sale.
10. If the issuer wants to optimize amortization schedules based on up-to-the-minute market changes;
11. If the issuer needs to complete the transaction in a very rapid timetable.

Competitive Sale Is Generally Best When:

1. Interest rates are stable with very little volatility;

2. All financing parameters are generally standard and can be established several weeks before the sale;

3. Issues are highly rated and can attract a large number of bids nationwide; low number of bids generally will result in high interest costs; and
4. The issuance of bonds does not require strategic timing and substantial flexibility.

Appendix B
Some Ways to Get Maximum Competition Into Negotiated Bond Transactions

The following are excerpts from an article published in the *Bond Buyer*, April 22, 1991, by J.D. Perko, Chief Financial Officer of the Washington Public Power Supply System.

1. Utilize a request for proposal for a financial advisor;
2. With help from your financial advisor, prepare a request for proposal for the selection of the managing underwriters;
3. In selecting your management group, select more than one senior banker. Tell them you are going to evaluate them after each sale based on certain identified criteria. You may rotate senior managers, but make no guarantees;
4. Re-bid your bankers once a year;
5. Get to know the individuals very well on the underwriting side of your senior managers---not just the public finance banker;
6. Negotiate fees;
7. Identify your objectives as clearly as possible to your underwriters and then hold them accountable to achieve them;
8. Involve your governing body.
9. On the day interest rates are set, make the underwriters justify any sizing changes (increases) with concessions on price and spread.

If you are able to instill into your underwriters and especially your senior managers the spirit of competition, then you can have a higher level of confidence that you truly have the best interest rates for your transaction.

Note: The Washington Public Power Supply System typically issues bonds from $50 million to $700 million. References to management groups, multiple investment bankers and underwriters may not apply to school districts issuing bonds from $1 million to $10 million. However, concepts describing ways to maximize competition in negotiated transactions are applicable.

Auditor General's Response

Attached to this report is a letter prepared by Robert S. Prince of the law firm Kirton, McConkie & Poelman, legal counsel for the Utah School Districts Finance Cooperative. Most of the issues raised in Mr. Prince's letter are adequately addressed in the report. However, we feel there are three issues where Mr. Prince has not clearly understood our position. This response will attempt to clarify our position on those issues.

First, Mr. Prince makes reference to a sentence in our report and to a meeting held on May 31, 1994 in which we stated that we found no evidence of fraud or inappropriate activities in our review of the subsidy program. Mr. Prince has used these statements several times in his letter to imply that we endorse the current administration of the subsidy program and that we find the program to be legally valid. While it is true that we did not find any evidence of fraud or inappropriate activities in our review, it is important to emphasize that our review was a very limited scope survey, not a full audit, of the Finance Cooperative's subsidy program. Therefore, our statement should not be interpreted as an endorsement of the subsidy program. We did not review the expense accounts, travel and entertainment records, or financial statements, of the cooperative or the firms involved in the program.

Second, Mr. Prince refers to the $1,132,638 in subsidies awarded thus far by the cooperative as "savings" to school districts participating in the program. We disagree with the classification of the subsidy award as a savings to the districts. The cooperative has not conducted any analysis demonstrating that districts participating in the subsidy program experience a net savings over and above districts not participating in the subsidy program. In order to calculate the savings, a study would have to be performed comparing the best possible deal a district could receive on the open market with the deal they receive through the subsidy program. In our opinion, it is incumbent upon the cooperative to conduct such studies before characterizing subsidy awards as savings. School district officials should not be lead to believe that they will receive a savings by participating in the subsidy program unless such savings can be documented.

Third, Mr. Prince indicates that the subsidy program promotes competition by providing school districts with an alternative means of issuing bonds. We disagree with this position. The subsidy program does not offer school districts an alternative means of issuing bonds. Under current policy, school districts participating in the subsidy program must issue bonds through a negotiated sale. As noted in our report, negotiated sales are one of the two most common methods used to bring bonds to market. Our objection to the subsidy program is over the exclusive arrangements for bond underwriting and bond counsel granted by the cooperative. In our opinion, the exclusive arrangements fail to promote competitive practices. We do not understand why firms of the national expertise and reputation like those granted the exclusive arrangements by the cooperative need the protection of an exclusive arrangement. We do not understand the reluctance of the cooperative to introduce competitive practices designed to ensure that districts receive competitive market rates.