27h2

Gov Agency: Administration—Expansion of Master Lease Program

Recommendations:

Paper No. 181	Technical Changes to Existing Program:	Alt. 1
	Expansion of Program to Municipalities:	Alt. 3

Comments: DOA is proposing that the state master lease program be expanded to include municipalities. The first half of the alternatives amends current law to include some technical changes, and they all look fine. The question of expansion is the bigger part of the paper, and it's kind of difficult to call. LFB lays out several reasons as to why expansion is a bad idea, mainly that it adds a higher credit risk to the state program. (See paragraph 23.)

Washington state recently expanded their program to include municipalities. They designed their program in such a way that it reduces credit risk to the state (see point 28). LFB lays out several alternatives for the Committee mostly designed to minimize credit risk to the state. Alternative 2(c) would establish a separate municipality master lease program, thereby eliminating the credit concerns, however it's not clear how well it would work.

Since, there are so many questions about this expansion, it's probably best to go with Alt. 3 which directs DOA to study the idea and submit a report to JFC. Seems better to look into the idea further instead of going forward with so many unresolved issues.

If the Committee is inclined to expand the program, they should probably adopt an alternative under Alt. 2 so as to reduce the credit risk to the state. Alts. 2 (c), (d), and (e) would accomplish that goal.

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Expansion of Master Lease Program (DOA -- General Statutory Provisions)

[LFB 1999-01 Budget Summary: Page 73, #2]

CURRENT LAW

Under current law, the state master lease program may be used for the lease of goods or the provision of services on behalf of one or more state agencies. The types of financing are enumerated in the statutes. Under current law, fiscal agent services for this program are exempt from the requirements governing contractual services and lowest responsible bidder requirements, but the master lease contracts are not. The current process of perfecting security interest is necessary to determine the order of ownership of a property dispute. This is normally done by filing a notice of security interest with DFI. Master leases are currently exempt from the uniform commercial code and DOA may grant a security interest rather than DFI.

GOVERNOR

Amend current law regarding the state master lease program as follows:

Expand basic authority regulating the use of master leases. Modify current law to allow DOA to enter into a master lease to obtain property or services, rather than for the lease of goods or the provision of services. Specify that a master lease may not be used to obtain a facility for use or occupancy by the state, a state agency, or any other instrumentality of the state or to obtain an internal improvement. Broaden the authority of DOA to enter into varied financing agreements, which the Department determines are necessary to facilitate the use of a master lease, and repeal the seven specific financing tools currently identified in the statute (liquidity facilities, re-marketing or dealer agreements, letters of credit, insurance policies, interest rate guarantees, reimbursements and indexing agreements). Exempt master leases from the statutory requirements governing contractual services and lowest responsible bidder requirements. Lastly, clarify the uniform commercial code exemption for master leases from the requirement to file a perfect security interest with DFI. Require DOA to record and preserve the record of perfect interest throughout the master lease and clarify that master leases have priority of interest over conflicting interest of an encumbrancer or owner of the real estate.

Municipalities. Authorize the use of state master leases for municipalities and create an appropriation to expend monies received from municipalities to make state master lease payments. Provide that use of a master lease by a municipality would be restricted to obtaining property or services related to public safety functions of the municipality. Specify that when DOA uses a master lease on behalf of a municipality, the Department is required to enter into an installment sales contract with the municipality to obtain any property or service. Specify that the municipality shall issue a general obligation promissory note to DOA as security for the property or services obtained under the master lease. In addition, stipulate that a state agency's ability to use a master lease may not be dependent upon payment by a municipality unless the obligation of the municipality constitutes a general obligation.

The master lease program cannot currently be used to finance municipal purchases.

DISCUSSION POINTS

Background

1. DOA was authorized to establish the current master lease program by 1989 Wisconsin Act 31, the 1989-91 budget, and the program actually began operation in 1992. The purpose of the program is to provide an option for state agencies to finance at a reasonable interest rate the acquisition of capitalized assets over a period of time rather than having to meet those costs all as a one-time purchase arrangement. Advantages of this approach are that it does not require a major one-time increase in appropriations for a large purchase and takes advantage of state borrowing costs that are lower than vendor lease purchasing or other individual agency financing arrangements.

2. The master lease program may be used to purchase capitalized assets which include equipment, services related to computer software and systems project development and implementation, and certain prepaid services. Leases for equipment may include items as varied as furniture, printing presses, computers or tractors. The contractual services for software or systems development are for consultant services used to develop software, operating systems or database management systems that when completed add value to the physical asset (IT hardware) that is being installed. Prepaid services could include prepaid distance education services or telecommunications services. The master lease program may not be used for acquiring real estate or buildings.

3. Since the inception of the master lease program, leases totaling over $186 million have been originated. The current outstanding balance of master lease payments is approximately $49 million. As an indication of what the leases are being used for, the outstanding balance of items obtained under the master lease as of January of this year consisted of 81% for equipment, 12% related to software and systems development, and 6.5% related to pre-paid service items.

4. If an agency wishes to use the master lease program, a request must be submitted to DOA's Capital Finance Office. The Capital Finance Office and DOA Budget Office review the request to ensure that: (a) the requested equipment is eligible for financing through the master lease program; (b) master lease financing is the best alternative; and (c) adequate funds exist for making the lease payments. If the request is for information technology items, the Division of Technology Management in DOA will also review the request. An agency's request for master lease financing must also indicate the desired length of the lease and any downpayments that an agency may want to make. Master lease payment terms may not exceed the useful life of the asset which for non-IT equipment is a maximum of seven years and for IT equipment is a maximum of three years. The current average lease length is slightly under two years (1.9 years).

5. Upon approval by DOA, the agency purchases the equipment or service and the bill is submitted to the Capital Finance Office which handles the vendor payments through the master lease program and automatically deducts the agreed upon payments from the agency's appropriation(s) to repay the master lease financing arranged by the Capital Finance Office.

6. To provide for the actual master lease payments, the Capital Finance Office uses a two-phase financing structure. In the first phase, all leased items are originally purchased by the state with revenues available from a revolving line of credit. This line of credit, currently $50 million, is with the Bank of America NT&SA and the state pays interest based upon a variable, taxable interest rate (currently about 5.25%). The line of credit is used because payments for the individual master lease purchases are sporadic, as they occur after an item has been installed and accepted. The use the line of credit financing minimizes the costs of up-front borrowing and the risk of non-origination of credit after a purchase has been approved. Agency payments are then based on a lease-payment schedule.

7. In the second phase, the state sells certificates of participation (COPs), which are a bond-like form of financing, to refinance the line of credit at a lower interest rate. The COPs are issued for the purpose of providing fixed-rate funding for a group of master lease repayment schedules which were initially financed through a variable-rate taxable line of credit. The COPs are issued periodically, as the line of credit is used up, to restore the balance in the remaining credit line. The interest rate on the latest tax-exempt COPs was 3.68%. The COPs sold for the master lease program are generally tax-exempt, with the exception of recent Badgernet financing because this involved a prepaid service and federal law requires the state to use taxable financing instruments for such items. The state is required under the master lease program to make payments from any source of legally available funds, subject to the appropriation process. However, COPS do not constitute a debt of the state or any of its political subdivisions.

8. Two additional features of the master lease program are relevant to the financing costs of the master lease program. First, the title and security interest for all equipment financed by a master lease is held by a Trustee (Firstar Bank in Milwaukee) until the lease has been repaid. This provides the lenders collateral in the case of default. Second, all the property that is financed through the master lease is cross-collateralized. This means that non-payment by any one agency would result in an event of non-payment for all items financed under the master lease program. The state cannot separately identify payment for some equipment but not other equipment. Both of these features provide borrowers with greater security and lower the risk to the borrowers and

therefore, are designed to lower the interest rate that would otherwise be charged to the state.

Governor's Proposal: Technical Changes

9. Under the Governor's proposal, the bill would make the following technical modifications to the current master-lease program:

- Amend the definition of what is eligible for purchase under the master lease program from "for the lease of goods or the provision of services" to "to obtain property or services." The term goods is replaced with property because DOA bond counsel has indicated that goods is not currently defined in the statutes and connotes moveable property which are not the only items that agencies purchase through the master lease program. The substitution of the word obtain for lease was included because the leasing under program really represents installment purchases and the concept of "leasing services," if compared to the leasing of permanent property, is not a logical construction.

- Create a statutory provision prohibiting the use of the master lease program for obtaining a facility for use or occupancy by the state or an agency or instrumentality of the state or to obtain an internal improvement. The Building Commission is responsible for making decisions regarding acquisition of state office buildings through the state building program; however, given the above statutory change to substitute property for goods, this language would clarify current law.

- Eliminate the enumeration of specific financial instruments that DOA may use under the master lease program and instead authorize DOA to use any financial arrangements which the Department determines to be necessary to facilitate the use of the master lease program. This change has been proposed because Legislative Reference Bureau drafting attorneys have indicated that the enumeration of some types of financial instruments that may be used could possibly be construed by a court to restrict DOA to only those types of financing mechanisms listed in the statutes. DOA wants to have the authority to use other financing mechanisms that may arise if they would reduce borrowing costs.

- Amend the statutes to clarify that DOA, not DFI, is responsible for keeping records regarding ownership of the property obtained using a master lease. This would reflect the actual current practice.

- Exempt master lease financing mechanisms from the statutory requirements governing contractual services and use of the lowest responsible bidder. This provision was requested to allow DOA to obtain unique financial instruments that might be selected based on negotiated arrangements.

10. The Governor's recommendations to amend the statutes regarding the eligible uses of master leases by state agencies, the prohibition against obtaining state buildings, the financing mechanisms available to DOA, and the private security interest reporting are all statutory modifications that either improve DOA's ability to run the program or codify current practice. The Committee could approve these amendments to the statutes governing the current master lease program.

Governor's Proposal: Expansion of Master Lease Program

The Governor's recommendations in this area would provide for a major expansion of the current master lease program. The bill would:

- Authorize the expansion of the master lease program to allow municipalities to obtain property or services related to public safety functions of the individual municipality. To participate in the program, a municipality would be required to issue a general obligation promissory note to DOA as a security for any property or services to be obtained under the master lease program.

- Amend current law to stipulate that state agencies' ability to use the program would not be dependent upon any master lease payment by a municipality unless the obligation of the municipality has been established as a general obligation of the municipality by passing a resolution and with the concurrence by the chief executive officer of the municipality.

11. Allowing municipalities to use the existing master lease program would expose the program to an unknown demand for additional major lease financing and would also add potentially significant credit risk considerations to the program. The following question may be raised regarding the proposal.

- Should the program be expanded to municipalities?

- What entities would be included under the term municipality?

- What property and services would be appropriate for municipalities to finance through the proposed master lease program?

- Are there any additional risks associated with the proposed program expansion, and if so, what safeguards are appropriate to protect the state?

Why Expand the Master Lease Program?

12. Secretary Bugher has indicated that the reason for expanding the master lease program to municipalities was in response to requests made by a number of municipalities to have access to lower borrowing costs.

13. Presumably, the primary reason to allow municipalities to use the master lease program is the expectation they could save money by using the state's master lease program because it offers access to lower cost borrowing than they would otherwise be able to obtain. It has been indicated that municipalities often will not borrow to purchase equipment, and even if they do, they likely do so at higher costs than if they were eligible to use the state's master lease program. Costs could be lower because: (a) municipalities would be able to take advantage of economies of scale; (b) lower interest rates; and (c) lower administrative costs because program costs would be shared amongst all users.

14. The Capital Finance Office, which would operate the program, has not conducted

any detailed analysis on which Wisconsin municipalities might use the program or the savings that might be likely to accrue to municipalities. Providing any estimate of potential savings that might accrue to the municipalities is difficult. Some indication however, might be gained by comparing the average current borrowing costs of municipalities to that of the current master lease program to provide an illustration of relative interest costs. The table below provides a comparison of the interest cost of a $100,000 transaction, amortized over four-years, at the current COPs interest rate, versus the average interest rate of the 114 Wisconsin municipal bond sales during the period of July, 1998, to November, 1998, and the highest interest rate assessed under those bond sales.

Comparative Interest Costs for $100,000 Purchase Repaid Over Four Years

	Master Lease COPs	Average Municipal Bond	Highest Municipal Bond
Interest Rate	3.69%*	4.46%	6.96%
Interest Cost	$8,456	$10,293	$16,284
Increased Costs Over Master Lease	N.A.	1,837	7,828

*Reflects most recent interest rate for COPs issuance (February, 1999). This interest rate does NOT reflect the higher interest rate (currently 5.25%). that is initially charged under the master lease line of credit financing.

15. In this example, a municipality whose bond interest rate was equivalent to the average rate indicated would have saved slightly more than $1,800 in interest costs over a four-year period if a bonded-for item could have instead been financed under the master lease program. At the highest interest rate, a municipality could have saved in excess of $7,800 or almost half of the total interest cost if a bonded-for item or items could have instead been financed under the state master lease program. It is important to note, however, that this is only an illustration of how rates might compare. Further, while the larger savings illustrated in the example might be impressive, it must be noted the municipalities that could save the most are presumably municipalities with higher credit risk rating based upon the bond market interest rates. Another important limitation of the comparisons in the table is that the initial interest under the master lease program, based on the master lease line of credit, is considerably higher than the COPs' interest rate and therefore, until a initial lease is refinanced as a part of a COP issuance, the savings would be less or nonexistent.

What Entities Would be Eligible? What Could be Master Leased?

16. Under the Governor's proposal, an eligible municipality would be a county, city, village, town, school district, board of school directors, sewer district, drainage district, technical college district or any other public or quasi-public corporation, officer, board or other body having the authority to award public contracts.

17. However, the bill would limit what any municipality may purchase through the master lease program solely to property or services which are related to public safety functions of

the municipality. A definition of public safety functions is not included in the bill. In addition, Capital Finance Office staff indicate that they currently do not have any definition of what would constitute public safety functions under the bill. However, some indication of what might be envisioned as public safety equipment can be gained from a September 30, 1998, Governor's Office press release which referenced a then potential initiative to help police and sheriff departments purchase crime-fighting equipment through the state master lease program. This press release suggested, as an example, that police departments would be eligible to buy everything from squad cars to computers under the master lease program.

18. The question could be raised whether it is appropriate to expand the master lease program to the broad range of governmental units recommended by the Governor or whether only a smaller subset of these organizations should be made eligible. It could be argued that the list of entities included in the definition of municipalities is very broad and that this could increase the credit risk of the current state-only program and thus the cost of the program to state agencies. One alternative would be to limit eligibility to school districts, counties, cities, villages and towns because of their broader tax base. However, a broader tax base is not necessarily a guarantee of lower risk. Further, these categories of municipalities may already have generally better access to lower cost financing than the other units of government that would be excluded, thereby reducing any overall potential benefits of the proposed expansion.

19. However, under the Governor's recommendation the scope of which municipalities would be eligible is already delimited in another sense because under the Governor's recommendation any otherwise eligible municipality could only use the master lease program to obtain property or services related to public safety functions of the municipality. Many special purpose districts would presumably not have any public safety functions and thus, would not be eligible to participate under the program.

20. It could also be argued that there may be a question whether expanding the master lease program to municipalities violates Article VIII, Section 3 of the Wisconsin Constitution which states that the credit of the state shall never be given, or loaned, in aid of any individual, association or corporation. Drafting attorneys in the Legislative Reference Bureau have indicated that if allowing municipalities to use the master lease program were to be determined by a court to constitute the giving or loaning the credit of the state, then this proposal would likely be held to be unconstitutional. Capital Finance Office staff indicate that they do not believe this to be an issue, but they are having state bond counsel review the issue.

What are the Possible Impacts on Credit Risk from Program Expansion?

21. It could be argued that expanding the current state master lease program to include municipalities may increase the degree of credit risk of the program compared to the degree of credit risk under the present program and thereby result in increased borrowing costs to state agencies. Unlike the control DOA has over state agencies, DOA does not control a municipality's finances and this adds uncertainty to the lenders who would purchase the COPs that repayment will occur. In addition, if a municipality does default, the cross-collateralization of the property financed through the master lease could potentially place state-purchased equipment at risk. The risk of an investment is usually among the principal concerns of investors and thus, is factored into the interest

payment that is required by the lenders before they will purchase the COPs as investments. If such increased interest rate charges occur, this would be factored into the interest payments that would be required from lenders and could result in an increase in interest costs charged to the whole program since the leasing to municipalities would be part of the same program as the leasing to state agencies.

22. The Governor proposes to minimize the credit risk to the state by requiring municipalities to issue a general obligation promissory note to DOA as a security that lease payments will be made. The bill also stipulates that state use of the master lease program cannot be dependent upon municipal repayments unless the municipal government recognizes its participation as a general obligation.

23. It could be argued, however, that a principal reason for not expanding the program to municipalities is that it adds the potentially higher credit risk, due to municipal participation, to the state program. The extent of that risk and any impact on state agencies costs, like the extent of any savings to municipalities, is currently unknown because there is no information on how many municipalities might participate or what their particular credit risk is. However, as the master lease program is structured under the bill, non-payment by a municipality would place the state in the position of having to: (a) allow a default which would negatively impact the state and the other participating municipalities' lease agreements; or (b) make the payment for the municipality to avoid default. Furthermore, under the Governor's proposal the entire state agency master lease program would be at risk in the event of a default because all equipment is cross-collaterized and the entire program would be negatively impacted if a municipality defaulted.

24. The question may be raised whether the Governor's proposal to require a general obligation promissory note from a participating municipality to DOA as security for any master lease purchase is a sufficient guarantee to protect the state from adverse credit risk impact to the existing program. While a general obligation promissory note constitutes an obligation of the municipality which would provide legal recourse to the state for payment if the note was not paid, the failure of the municipality to make payments on time could result in default of the entire master lease program, due to the cross-collateralization provisions of the program. In the case of the current state agency master lease program, DOA has numerous controls and powers to ensure that state agencies have sufficient funds available to make the necessary payments and to make timely payments. DOA automatically withdraws funding from an agency's appropriations when payments are due and the State Budget Office has controls to ensure that an agency has sufficient monies remaining to make the required payments. DOA does not have and would not have under the proposed language any similar powers with regard to borrowing municipalities.

25. There is at least one state that currently has a local government master lease program and that is the State of Washington. That program is briefly described below.

Washington State's Local Option Capital Asset Loan Program

26. The State of Washington has a state-operated leasing program that was recently made available to municipalities. The state has had master lease program for state agencies since 1989 and has issued over $40 million in certificates of participation to finance equipment and real

estate on behalf of state agencies.

27. Local governments of all types were newly authorized access to the program in September, 1998. Under the program, a broad range of municipalities are eligible to use the program including counties, cities, towns, fire districts, school districts, irrigation districts and housing authorities. In the seven months it has been available, the Local Option Capital Asset Lending (LOCAL) Program has issued $2,850,000 in certificates of participation to local governments. The equipment funded has include police cars, fire engines, x-ray equipment and school buses.

28. This program is of relevance to this discussion because it includes several protections designed to mitigate the credit risk to the state. Like the Governor's proposal, local governments' agreements to repay the state generally constitute a local general obligation pledge. However, the State of Washington's program also authorizes the state to withhold or intercept local government revenues collected by the state in the case of non-payment by the municipality of the lease. These revenues include sales taxes, use taxes, motor fuel taxes and other miscellaneous taxes. Lastly, the state is authorized to be the payor of last resort in the event a local government defaults. Payments are collected 30 days in advance so that the state can plan for the non-payment and arrange other sources of funds.

29. Information from that state indicates that interest rates under the program currently range from 4.26% to 4.51%, depending upon the length of the lease.

Discussion of Scope of Possible Alternatives

30. Given the lack of detailed analysis that has been conducted to date on the proposal concerning such questions as potential savings for municipalities, the possible impact on the state program's risk rating, and the constitutional question that has been raised regarding the expanded program, the Committee could delete the proposal from the bill. It could also add session law language directing DOA to study the issue and then submit separate legislation to the Joint Committee on Finance after additional analysis been undertaken regarding how such an expansion of the program could be established and what the likely impact would be on the current state-agency-only program. Analysis of and consideration of such items as possible impact on the program for state agencies, whether a completely separate program for municipalities but run by the state would be better, and what the extent of municipal interest in such a program would be among the concerns that could benefit from a more detailed evaluation of the issue.

31. Alternatively, municipalities could benefit financially from the creation of such a program. In that case, however, it could be argued that if allowing municipalities to use master lease financing for a given function such as public safety is of financial value, then it likely makes equal financial sense for other municipal functions as well. If the master lease program is to be made available to municipalities, then to be of the most benefit, municipalities should have the choice on how best to use this financing mechanism. Any municipality must make its purchasing decisions based upon both existing needs and budgetary constraints. It could be argued that limiting master lease financing arbitrarily to public safety functions could force municipalities to make acquisitions directed to public safety purposes over other necessary equipment purchases simply

because of the availability of lower cost financing. The Committee could modify the Governor's recommendation to delete the limitation of municipal use to only leasing for public safety functions.

32. One alternative the Committee could adopt to minimize the credit risk to the state program would be establish separate state agency and municipality master lease programs. This would mean that the current state agency program would not be directly affected by extension of a separate master lease program to municipalities. A separate alternative, if it is felt necessary to have a single master lease program, would be to provide under the program that DOA could attach state shared revenue payments or other state aid payments otherwise due a municipality as a remedy for non-payment under the master lease program. A third alternative, again if only a single master lease program for state agencies and for municipalities were to be established, would be to provide that in the event of default of a municipal borrower under the master lease program, the state would be the payer of last resort. Some type of reserve fund or open-ended appropriation to DOA would be necessary to accomplish this last alternative.

ALTERNATIVES

Technical Changes to Existing Program

1. Approve the Governors' recommendations to make technical changes regarding what may be leased, types of financing agreements that may be used under the program, exemption from low bid requirements and application of the uniform commercial code to such lease agreements.

2. Maintain current law.

Expansion of Program to Municipalities

1. Approve the Governor's recommendation to expand the current master lease program to municipalities for use only in obtaining property or services related to public safety functions of the borrowing municipality.

2. Modify the Governor's recommendation by adopting one or more of the following modifications:

a. Limit the definition of eligible municipalities to counties, cities, villages, towns and school districts.

b. Authorize eligible municipalities to use the program for the master lease of any otherwise eligible property or services under the program.

c. Provide that an entirely separate master lease program, which would have no affiliation with or impact on the operation of the current state agency master lease program, be established instead of establishing a single integrated program.

d. Provide that with regard to the granting of master leases to municipalities by the state, the Department of Administration would be authorized to withhold any state aid or share revenues payments otherwise payable to the municipality to the extent necessary to fulfill the municipality's lease payment obligation to the state.

e. Provide that with regard to the granting of master leases to municipalities by the state, the Department of Administration would be authorized, from funds to be reserved or otherwise made available for this purpose, to make any required lease payments of a municipality in the event that the municipality does not make such required payment or payments on a timely basis.

3. Maintain current law but include a session law provision directing DOA to study expansion of the master lease program to municipalities and to submit a report and draft legislation to the Joint Committee on Finance after additional analysis of how a proposed expansion of the master lease program to municipalities should best be structured and what the likely impacts would be on the state agency program.

4. Maintain current law.

Prepared by: David Worzala

MO# tech changes Alt. 1

2 BURKE	Y	N	A
DECKER	Y	N	A
JAUCH	Y	N	A
MOORE	Y	N	A
SHIBILSKI	Y	N	A
PLACHE	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
1 GARD	Y	N	A
PORTER	Y	N	A
KAUFERT	Y	N	A
ALBERS	Y	N	A
DUFF	Y	N	A
WARD	Y	N	A
HUBER	Y	N	A
RILEY	Y	N	A

AYE 15 NO 1 ABS ____

MO# Alt. 4

2 BURKE	Y	N	A
DECKER	Y	N	A
JAUCH	Y	N	A
MOORE	Y	N	A
SHIBILSKI	Y	N	A
PLACHE	Y	N	A
COWLES	Y	N	A
PANZER	Y	N	A
1 GARD	Y	N	A
PORTER	Y	N	A
KAUFERT	Y	N	A
ALBERS	Y	N	A
DUFF	Y	N	A
WARD	Y	N	A
HUBER	Y	N	A
RILEY	Y	N	A

AYE 13 NO 3 ABS 0