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CERTIFICATES OF PARTICIPATION

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The General Assembly will consider bills this session that authorize the state to enter into lease-purchase agreements to build capital facilities. If approved, the state's annual lease payments will be marketed to investors as certificates of participation (COPs). A "certificate" refers to an investor's proportionate interest in the state's lease payments. Proponents say that COPs give the state the flexibility to build capital facilities even when funds are not available to pay for the projects on a pay-as-you-go basis. Opponents, however, say that COPs cost more and should be subject to a vote of the people. This issue brief explains how COPs work, discusses advantages and disadvantages of COPs, and describes potential changes to the state's master lease program.

How COPs Work

Once the authority from the legislature is obtained, the state enters into a lease-purchase agreement with a *lessor* for a proposed facility, such as a prison. Under the state's master lease program, a nonprofit corporation comprising three state officials serves as the lessor for state leases. The state transfers its interest in the property to the lessor and leases it back through annual "lease" payments. The state, therefore, becomes the *lessee*. If the state owns the land beneath the leased facility, it also enters into a long-term ground lease.

After a negotiated or competitive bidding process, handled by a *financial advisor*, the state receives the money to construct the capital facility from an *underwriter*. The underwriter sells the certificates to investors. In the meantime, to secure the interests of the investors, the lessor assigns its interests to a *trustee*. The trustee is usually a commercial bank that holds title to the property, collects the lease payments from the state, and makes payments to investors.

The lessor structures the lease within the parameters set by law. The state makes annual lease payments authorized through the Long Bill that include both principal and interest. The interest rate paid by the state is fixed and depends on market conditions on the pricing date. The state renews the lease each year through the Long Bill appropriation. When the lease ends, the state owns the facility at no or minimal additional cost. The state may also purchase the leased property and terminate the lease early if state funding is available.

If the state fails to make the annual lease payment, however, the lease terminates and the trustee may sell, re-let, or otherwise dispose of the property, using the proceeds to pay the investors.

The role of investors. COPs are marketed to investors by the underwriter in the form of securities. Investors normally purchase the certificates in $5,000 denominations. Although the state makes annual payments, investors generally receive interest payments every six months and principal payments annually. In addition to market conditions on the pricing date, the interest rate earned by investors depends on the maturity date of the securities purchased. Investors who invest for the term of the COP receive a higher interest rate than those who purchase certificates with an earlier maturity date. In addition, the interest income earned by investors is exempt from federal and state taxation.

Legislation is Required

As noted, legislation is required before the state can enter into lease-purchase agreements to finance the construction of a capital facility. This authority cannot be conveyed in the Long Bill. A lease-purchase bill

generally specifies the maximum principal amount and maximum term of the agreement. The interest rate the state pays for COPs is approximately the same as it would pay for general obligation debt, assuming it could issue such debt, although insurance premiums are somewhat higher for COPs. Finally, the legislation indicates that the agreement is subject to annual appropriation by the General Assembly.

Advantages of COPs

The primary advantage of COPs is flexibility. COPs allow for the immediate availability of funds for needed capital projects, particularly in a time of limited state revenues. The state's budget difficulties have meant that even high-priority capital construction projects have not been funded in the past two fiscal years. Capital funding for upcoming years is also expected to be low. Without a funding source, the state's capital needs will continue to mount. The cost of delayed projects can also increase due to inflation.

In addition, lease payments on a COP issue can be structured to begin at a date of the state's choosing. This gives the state additional time to set aside funds for the annual payments, and could mean that the payments are made in a more favorable economic climate.

Finally, the state has used COPs for real property transactions only seven times since 1979. The state has shown restraint in financing projects only when sufficient funds were available to make the annual payments.

Disadvantages of COPs

The major disadvantages of COPs are financing costs and fixed long-term annual appropriations. Financing costs, primarily interest payments but also transaction costs, can make projects more costly than if they are funded with current dollars. This is particularly the case if the state chooses to begin lease payments at a later date and enters into a lease with a lengthy term. Substantial annual appropriations for COPs can also make it more difficult to fund other projects or programs.

Further, some people equate COPs with debt, which is strictly limited in Colorado. Although the state is under no obligation to make the annual lease payments on COPs, in practice it has made these payments a top priority. For the current fiscal year, for example, the two outstanding COPs funded through the capital budget were given the highest funding priority of all capital projects, and were fully funded despite the state's revenue problems.

Finally, failing to make the annual appropriation means that the entire investment in the COP would be lost, because the lease would be terminated and the property's proceeds used to pay off investors. A failure to make a payment would also have a negative impact on the state's credit rating and limit its ability to obtain insurance and use the capital markets.

Master Lease Program

In recent sessions, the General Assembly has considered bills to modify the state's master lease program. The master lease program allows the state to refinance, revise, replace, or consolidate state leases, including leases financed through COPs. It also provides that the lessor for state leases is a nonprofit corporation comprising three state officials. The proposed master lease changes stem from a Colorado Supreme Court decision, *Submission of Interrogatories on House Bill 99-1325*, 979 P.2d 549 (Colo. 1999). The court's ruling in *Interrogatories* suggests that any lease-purchase agreement the state enters into should be structured so that the lessor is independent from the state. As a result, the master lease bills have proposed creating a new board to serve as the lessor for state lease-purchase agreements, consisting of members who have experience in finance, real estate, or leasing, and who are not state officials or employees. The bills also include language stating that the leases are subject to annual renewal by the state and are secured only by the property that is the subject of the lease-purchase agreement. The rationale for these changes is to emphasize that the state is not pledging its credit for more than one year, meaning that COPs are not multiple-fiscal year obligations requiring a vote of the people pursuant to the Taxpayer's Bill of Rights (TABOR) constitutional amendment. Because none of these bills has passed, a master lease bill may be introduced in 2003.