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# County of Tulare

C. Brian Haddix
*County Administrative Officer*

Kristin Bennett, *Assistant County Administrative Officer*

**AGENDA DATE:** August 29, 2006

**SUBJECT: MILLENNIUM FUND ANNUAL STATUS REPORT AND DIRECTION REGARDING CALCULATION OF LEASE PAYMENT FOR FISCAL YEAR 2006-07**

**REQUEST:** That the Tulare County Public Financing Authority review the annual report from the program administrator regarding the status of the Millennium Fund and provide direction to staff and the administrator regarding calculation of the lease payment for fiscal year 2006-07.

**SUMMARY/JUSTIFICATION**: The program administrator for the Millennium Fund is Public Financial Management. Each year the administrator submits a comprehensive report listing the value of the fund and other pertinent information as of April 1st. As of April 1, 2006, the Millennium Fund is performing better than original projections by $1,443,730. These funds are specifically dedicated to maintenance and construction of County facilities, and they are deposited into the Capital Projects/Major Maintenance Fund. Tobacco settlement receipts are lower than projected, but the fund is still performing ahead of projections, in part because the fund was originally structured based on conservative revenue estimates.

A component of the annual report is the administrator's calculation of the amount to be deposited from the Tobacco Settlement Fund to the Bond Fund to cover costs for the following fiscal year. Costs include debt service and program fees. The standard method for calculating the debt service amount is to use a rate equal to the most recent reset rate plus 100 basis points (1 percent). Recent reset rates for the bonds have been quite low—the April 1, 2006 rate was 4.82 percent. The Administrator recommends that the Authority consider using the most recent reset rate plus 100 basis points (5.82 percent) to be sure that adequate funds are available for the coming year if rates rise. If rates do not rise, any unused amount in the Bond Fund is available for the following year, and interest is earned.

The County maintains a Letter of Credit for the Bond. It is an agreement between the County and a Letter of Credit provider where the provider pays the debt service to the bondholders directly and is then simultaneously reimbursed for these payments by the County. As the Bond has no Reserve Fund, the Letter of Credit serves as an additional assurance to bondholders that the debt service will be paid each month, and thereby helps to reduce the borrowing costs. The existence of a Letter of Credit is commonplace in transactions of this type.

The County renewed the Letter of Credit with Bayerische Landesbank and renegotiated the fee to 28 basis points on the outstanding par, rather than 30 basis points.

**ALTERNATIVES:** The Authority may select either the standard debt service estimate or the more conservative recommended level.

**ADMINISTRATIVE SIGN-OFF**

**C. Brian Haddix**
County Administrative Officer

CBH:ph

Attachment

Cc: Jerry Messinger, Auditor-Controller/Treasurer-Tax Collector
Kathleen Bales-Lange, County Counsel
Public Financial Management

# BEFORE THE BOARD OF SUPERVISORS
# COUNTY OF TULARE, STATE OF CALIFORNIA

| | | |
|---|---|---|
| **IN THE MATTER OF MILLENNIUM FUND ANNUAL STATUS REPORT AND DIRECTION REGARDING CALCULATION OF LEASE PAYMENT FOR FISCAL YEAR 2006-07** | )<br>)<br>)<br>) | **RESOLUTION NO. ______** |

UPON MOTION OF SUPERVISOR ________________________, SECONDED BY SUPERVISOR __________________, THE FOREGOING WAS ADOPTED BY THE BOARD OF SUPERVISORS, AT AN OFFICIAL MEETING HELD ________________________, BY THE FOLLOWING VOTE:

AYES:
NOES:
ABSTAIN:
ABSENT:

ATTEST: C. BRIAN HADDIX
COUNTY ADMINISTRATIVE OFFICER/
CLERK, BOARD OF SUPERVISORS

BY: ______________________________
Deputy Clerk

* * * * * * * * * * *

Approved review of the annual report from the program administrator regarding the status of the Millennium Fund and directed the administrator to use the recent reset rate plus 100 basis points (5.82 percent) in calculation of the lease payment for fiscal year 2006-07.

PFM
The PFM Group
Public Financial Management, Inc.
PFM Asset Management LLC
PFM Advisors

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May 31, 2006

Mr. Brian Haddix
County Administrative Officer
Tulare County
Tulare County Administration Building
2800 West Burrel Avenue
Visalia, CA 93291-4582

Dear Mr. Haddix:

As required annually by the Program Administration Agreement dated December 1, 1999, Public Financial Management, Inc., in its role as Administrator, is providing this report to update the County of Tulare (the "County") on the status of the Millennium Fund Program (the "Program").

**Executive Summary**

The Millennium Fund Program has provided sufficient funds necessary to cover the associated administrative costs of the Program. As of April 1, 2006 the market value of the Program exceeds the outstanding principal of the bonds by $5.9 million, which is $1.4 million ahead of the Program's original projections. This is due to cumulative performance of the investment program above that assumed in the forecast upon which the Millennium Fund Program was undertaken in 1999. The Fund has provided over $13.7 million in appropriations to the County since 1999. In addition to these past appropriations, the Fund will once again provide the County with an additional $2.5 million in the coming Fiscal Year.

**Market Valuation**

| Tulare County Millennium Fund Program<br>Market Valuation as of April 1, 2006 | |
|---|---|
| **Fund Name** | **Market Value** |
| Bond Fund | $396,136 |
| Millennium Fund | $48,307,717 |
| Tobacco Settlement Fund (TSR) | $192 |
| **Total** | **$48,704,044** |

## Unwind Position

The table below shows that the market value of the Millennium Fund Program exceeds the outstanding par value of the bonds by $5,904,044. This is $1,443,730 more than the original December 16, 1999 projections of the value of the funds for this point in time.

| Unwind Position as of April 1, 2006 | |
|---|---|
| Principal of Bonds Outstanding | $42,800,000 |
| Market Value of Millennium Fund Program | $48,704,044 |
| Unwind Exposure[2] (Difference between Market Value and Par) | $5,904,044 |
| **Original Projections for April 1, 2006[1]** | |
| Original Projection -- Principal of Bonds Outstanding | $42,800,000 |
| Original Projection -- Market Value of Millennium Fund Program | $47,260,315 |
| Original Projection -- Unwind Exposure | $4,460,314 |
| **Difference Between Current and Original Projections** | |
| Difference between Current Unwind Exposure and Original Projection of Unwind Exposure | $1,443,730 Favorable |

1. *As of December 16, 1999*
2. *Positive = benefit, Negative = exposure*
3. *In 2003, the County withdrew a distribution of only $1,223,359, rather than the expected $2,500,000 that was originally projected.*

## Appropriations

To date, the County has appropriated a total of $13,723,359 from the Millennium Fund Program for planned capital expenditures. The appropriations were made in accordance with Section 5.03(c) of the Indenture.

**Past Appropriations**

| Year | Appropriations |
|---|---|
| 2000 | $2,500,000 |
| 2001 | $2,500,000 |
| 2002 | $2,500,000 |
| 2003 | $1,223,359* |
| 2004 | $2,500,000 |
| 2005 | $2,500,000 |
| **Total** | **$13,723,359** |

* *In 2003, the County withdrew a distribution of only $1,223,359, rather than the expected $2,500,000 that was originally projected.*

The County has the option to withdraw an amount equal to the lesser of $2,500,000 or the excess of the aggregate market value of assets held by the Trustee in the Millennium Fund, Bond Fund and the TSR Fund as of the preceding April 1 over the outstanding principal amount of Bonds. As of April 1, 2006, this available amount is equal to $2,500,000. This appropriation will be available on July 1, 2006.

**Tobacco Settlement Receipts**

The County received a tobacco settlement payment of $3,651,026 on April 15, 2006. This payment was approximately $438,000 less than payments that were assumed for April 15, 2006 by the original projections when the Program was undertaken. Since inception, the cumulative variance between projected and actual receipts has been about $450,000 less than was originally expected. This shortfall was more than compensated for by cumulative out-performance of the investment program of approximately $1.9 million since Program inception, with the overall result that the Millennium Fund is now about $1.4 million higher than originally forecast.

| Date | Actual Payments | Original State Projections | Updated State Projections (2003) |
|---|---|---|---|
| 1/26/2001 | $1,166,214 | $1,288,451 | $1,288,451 |
| **4/25/2001** | **$2,415,151** | **$2,350,080** | **$2,350,080** |
| 1/04/2002 | $1,116,962 | $1,310,262 | $1,310,262 |
| **4/17/2002** | **$3,222,637** | **$3,106,823** | **$3,106,823** |
| 1/03/2003 | $1,335,612 | $1,315,326 | $1,315,326 |
| **4/15/2003** | **$3,339,206** | **$3,118,831** | **$3,268,463** |
| 4/15/2004 | $3,879,381 | $3,949,862 | $3,905,315 |
| **4/15/2005** | **$3,977,945** | **$4,024,713** | **$3,956,230** |
| 4/15/2006 | $3,651,026 | $4,088,870 | $4,042,695 |
| **Total** | **$24,104,134** | **$24,553,218** | **$24,543,645** |
| Variance - Actual to Projections | | ($449,084) | ($439,511) |

**Annual Lease Payment**

Section 403 of the Lease Agreement requires a deposit into the Bond Fund of an amount equal to the difference between the amount on deposit in the Bond Fund on June 1, 2005 and the Gross Lease Payment for the following fiscal year. The Gross Lease Payment comprises the estimated debt service and Program fees for the coming year.

The procedure for estimating the next year's debt service under the Lease Agreement entails calculating the interest payments using an interest rate equal to the most recent reset rate plus 100 basis points (1.00%). Because the bonds themselves are variable-rate issue whose interest rate is reset on a monthly basis, tied to current short-term rates, the additional 100 basis points provided a cushion should rates rise during a fiscal year. For the past few years, because of existing market conditions, PFM recommended a rate equal to the most recent rate plus 150 basis points (1.50%). This strategy proved to be prudent as the borrowing rate on the bonds did in fact increase sharply over the past two years in response to Federal Reserve rate hikes. The Bond Fund was sufficient to cover interest payments to date. For example, in Fiscal Year 04-05, the borrowing rate increased from 1.50% to 3.09%, and in Fiscal Year 05-06, we have seen the borrowing rate climb from 3.12% to 4.87%.

At this time, it is likely that the Fed is nearing the end of its tightening cycle, so it is not necessary to use the higher estimate for future debt service. The reset rate for the Bonds on April 1, 2006 was 4.82%; therefore, we will calculate the estimated debt service for the following year at a rate of 5.82%.

| Tulare County Millennium Fund Program<br>Fiscal Year 2006 Estimated Debt Service and Fees | | |
|---|---|---|
| **Type of Fee** | **Payee** | **Estimated Cost** |
| Debt Service | Bondholders | $2,966,710 |
| Letter of Credit | Bayerische Landesbank | $121,726 |
| Re-marketing | Morgan Stanley Dean Witter | $42,972 |
| Trustee/Draw Fees | BNY Western Trust | $18,499 |
| Management & Administration | PFM Asset Management LLC | $58,778 |
| **Total** | | $3,208,685 |

1. *Reset rate was 4.82% as of April 1, 2006, so future debt service is estimated at 5.82%.*

The anticipated Gross Lease Payment due from the County on or before July 15, 2006 will be $3,208,685.

As of April 1, 2006, the Bond Fund had $396,136 on deposit, which is sufficient to cover the debt service payments and fees for April and May. When calculating the transfer for Fiscal Year 2006-07, it will be necessary to include the June debt service and fees, estimated to be approximately $224,000.

The Lease Agreement requires that the County transfer sufficient funds from the tobacco receipts invested in the TSR Fund to the Bond Fund on June 1, 2006, so that the balance of the Bond Fund equals the Gross Lease Payment as estimated by the Program Administrator. The funds remaining in the TSR fund will be transferred to the Millennium Fund on June 1, 2006. The details are listed in the chart on the following page.

| Net Transfers To Millennium Fund (Balances as of April 1, 2006) | |
|---|---|
| **FISCAL YEAR 2006-07 LEASE REQUIREMENT** | |
| Gross Requirement | $3,208,685 |
| Plus: Amount Required for June 1 Debt Service Payment and Fees | + $224,219 |
| Net Requirement/Deposit to Bond Fund on June 1, 2006 | $3,432,904 |
| **FISCAL YEAR 2005-06 TOBACCO RECEIPTS** | |
| April 2006 Payment | $3,651,026 |
| **NET TRANSFER TO MILLENNIUM FUND** | |
| Actual Tobacco Receipts | $3,651,026 |
| Less: Net Requirement/Deposit to Bond Fund | - $3,432,904 |
| Estimated Transfer to Millennium Fund on June 1, 2006 | 218,122 |

**Investment Strategy**
The investment strategy for each of the funds associated with the Millennium Fund Program is described below.

**Tobacco Settlement Fund (TSR).** This account is funded once a year on or around April 15. Funds in the TSR account are transferred to the Bond Fund on June 1 in an amount sufficient to cover the next year's Gross Lease Payments as described above. All remaining funds in the TSR are transferred to the Millennium Fund, also on June 1. Between the time of the deposit of the settlement payments and transfer to the other funds, funds in the TSR are invested in high-quality, short-term investments targeted to mature on or before the transfer date. Once transferred, funds are invested in accordance with the strategy for the respective fund.

**Bond Fund.** Funds in this account are used to pay debt service and various administrative costs for the next fiscal year. Debt service is paid monthly, while most administrative fees are paid quarterly. Because of the short-term nature of the liquidity needs of the Bond Fund, a short-term investment strategy has been designed to provide adequate liquidity while minimizing risk. As such, these funds are invested in high-quality, short-term money market investments with maturities of one to three months, generally matched to the bonds' monthly reset dates – the first business day of each calendar month. This strategy is designed to ensure that funds are available to pay debt service and other fees, and that the investment rate on the Bond Fund will mirror the borrowing rate on the Millennium Fund bonds. For example, if short-term rates were to rise, the borrowing rate would rise at the next bond reset date. With investment maturities matched to the same reset dates, investments would be rolled over at the same higher rates, matching the Bond Fund's liabilities. The result over time has been effective liquidity management. Because of the sharply rising rate environment during this past year, we focused on 1-month investments to capture higher rates each month as investment were rolled over.

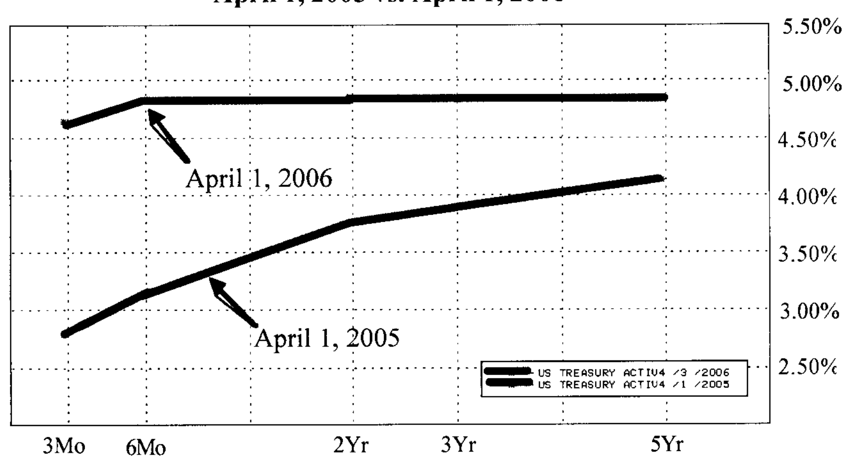
**Millennium Fund.** The County established several key objectives that drive the management of the Millennium Fund: (1) to achieve and maintain parity, so that the County would have the necessary resources to unwind the transaction if tobacco settlement proceeds were interrupted; (2) maximize the return spread on the Millennium Fund consistent with the liability requirement of the Fund in order to grow the fund over time, to minimize market or credit risk, and to provide annual appropriations; (3) carefully control risk on the Program to ensure its ongoing success; and (4) invest in accordance with the trust indenture governing investment of Millennium Fund bond proceeds.

PFM has designed a flexible and low-risk investment strategy to meet all these objectives. In the current interest rate environment, PFM has focused on minimizing the risk associated with sharply rising interest rates. Given the rapid rise in short-term interest rates over the past two years, we maintained a conservative investment approach designed to protect market value and allow for capturing new, higher rates as they have risen. We avoided locking the bulk of the funds into long-term securities which might subject the investments to significant market value losses or prevent the Fund from maintaining a positive investment spread if interest rates rise quickly.

The goal has been to achieve a positive spread over an interest rate cycle of at least 50 basis points between the earnings rate on the funds and the borrowing rate on the bonds—an approach which would generate approximately $178 million in benefits to the County over the life of the bonds. In addition, once the bonds are paid off in 20 years, the Millennium Fund endowment will continue to provide funds to the County for years to come. We note that the Program achieved parity in January 2003, well ahead of schedule. This is important because it means that even if there were to be a significant shortfall of tobacco revenues, the Millennium Fund itself could be used to pay off the Bonds at essentially no cost to the County.

During the past year, there have been significant changes in the market that impacted the Millennium Fund investment strategy. First, short-term rates increased very sharply, as a result of multiple rate hikes from the Federal Reserve; causing the borrowing rate on the bonds to increase very rapidly. In addition, the yield differential between short and intermediate-term investments significantly reduced over the year, as can be seen in the chart below.

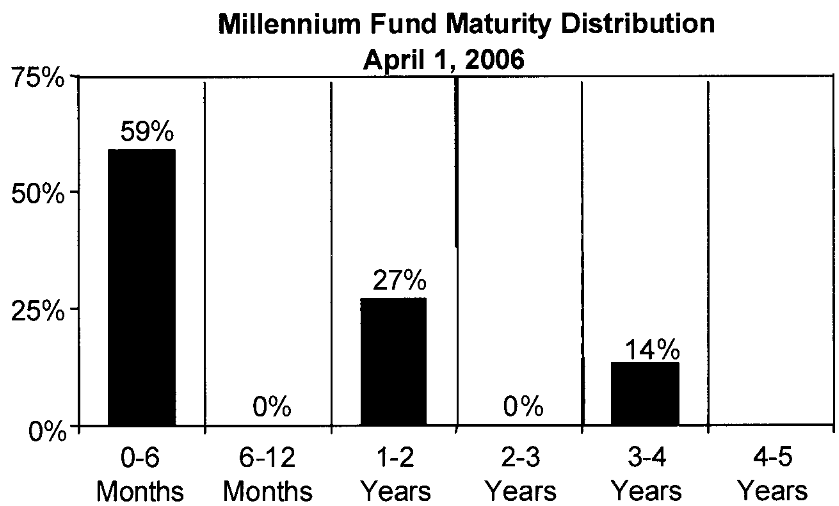
**U.S. Treasury Yield Curve**
**April 1, 2005 vs. April 1, 2006**




*Source: Bloomberg*

The consequences of these two shifts in the market has been that, for the moment, longer-term investments no longer offer yields that will provide a 50 basis point earnings spread over the borrowing rate. While last April, 2-year investments had rates that were approximately 1.00% greater than short-term investments, this April, the yields on these two investments are virtually the same. A year ago, had funds been invested in the two year maturity range to capture this initial spread, by now the two year investment—with a year remaining until maturity—would be at a yield that was in fact 100 basis points less than the current borrowing rate. This change is also significant because it means that the borrowing rate on the bonds is very close to intermediate-term yields, where we normally invest the Millennium Fund.

We have positioned the portfolio to keep pace with rising short-term rates. Nearly 60 percent of the Millennium Fund portfolio has maturities between now and June 30, 2006, as can be seen on the following chart.




The short maturity structure of the portfolio will enable us to capture rising rates in the portfolio as they continue to increase. We also have continued to look for investment structures that will enable us to enhance the earnings rate of the portfolio. For example, in February, we purchased a 3-year, step-up, callable Federal Agency note yielding 5.78%; this note compares favorably with the current borrowing rates of 4.62%. In addition, during Fiscal Year we withdrew $13 million from LAIF and invested generally in short-term commercial paper to achieve yields far in excess of what LAIF was paying (LAIF generally lags the market in a rising rate environment.). We are being cautious about adding too many longer-term investments while short-term rates are still trending upwards, seeking to find a balance between capturing higher longer-term yields today and preserving our ability to place investments at the new higher rates if yields continue to trend upwards. This may mean that for a period of time the spread between the portfolio yield and the bond rate will be les than 50 basis points, but as the Fed nears the end of its tightening cycle and short-term interest rates stabilize, we will be able to restructure the investment portfolio to recapture the spread. This would be similar to the history of the fund's performance form inception to date.

**Investment Results**
As of April 1, 2006, the cumulative earnings rate on the investments since inception has exceeding the aggregate borrowing rate by approximately 36 basis points, as can be seen in the chart below. While the spread is lower than in prior years due to current market conditions, the spread is still significantly positive and the program overall continues to be well ahead of originally projections. Additionally, the program is $1.4 million ahead of original projections, with an unwind value of $5.9 million. We will continue to closely monitor the market and will alter our investment strategy as necessary to reflect current market conditions. We will advise the County on the impacts of the investment climate going forward.

| Investment Results<br>December 17, 1999 to April 1, 2006 | |
|---|---|
| Average Investment Return | 3.55% |
| Average Borrowing Rate | 3.19% |
| **Spread to Return** | **36 basis points** |

If you have any questions, please call Lauren Brant or Nsesa Kazadi at 415-982-5544 or me at 717-232-2723.

Sincerely,
**Public Financial Management, Inc.**

Marty Margolis
Managing Director

cc: Jean Rousseau, *Tulare County*
Vern McDonald, *Tulare County*
Karen Mabry, *Tulare County*
Joseph Campagna, *Bayerische Landesbank*
Priscilla Dedoro, *BNY Western Trust*