

CITY OF DESERT HOT SPRINGS

Audit Report

SPECIAL GAS TAX STREET IMPROVEMENT FUND

July 1, 2008, through June 30, 2013

TRAFFIC CONGESTION RELIEF FUND

July 1, 2008, through June 30, 2011

PROPOSITION 1B FUND

July 1, 2008, through June 30, 2013



JOHN CHIANG
California State Controller

November 2014



JOHN CHIANG
California State Controller

November 18, 2014

The Honorable Adam Sanchez, Sr.
Mayor of the City of Desert Hot Springs
65950 Pierson Boulevard
Desert Hot Springs, CA 92240

Dear Mayor Sanchez:

The State Controller's Office audited the City of Desert Hot Springs' Special Gas Tax Street Improvement Fund for the period of July 1, 2008, through June 30, 2013. We also audited the Traffic Congestion Relief Fund for the period of July 1, 2008, through June 30, 2011, and the Proposition 1B Fund for the period of July 1, 2008, through June 30, 2013.

Our audit found that the city accounted for and expended its Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund, and Proposition 1B Fund in compliance with requirements, except that the city understated the fund balance in the Special Gas Tax Street Improvement Fund by \$119,685 as of June 30, 2013, because it charged unallowable debt service payments of \$119,000 to holders of the certificates of participation in fiscal year 2012-13; and understated the fund balance in the Special Gas Tax Improvement Fund by \$685 as of June 30, 2013, because the city incurred expenditures in excess of available funds.

In addition, we identified an observation relating to the city's going concern.

If you have any questions, please contact Mike Spalj, Acting Chief, Local Government Audits Bureau, at (916) 324-6984.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

JVB/sk

cc: Amy Aguer, Administrative Services Director
City of Desert Hot Springs

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Audit Report

Summary

The State Controller’s Office audited the City of Desert Hot Springs’ Special Gas Tax Street Improvement Fund for the period of July 1, 2008, through June 30, 2013. We also audited the Traffic Congestion Relief Fund for the period of July 1, 2008, through June 30, 2011, and the Proposition 1B Fund for the period of July 1, 2008, through June 30, 2013.

Our audit found that the city accounted for and expended its Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund, and Proposition 1B Fund in compliance with requirements, except that the city understated the fund balance in the Special Gas Tax Street Improvement Fund by \$119,685 as of June 30, 2013, because it charged ineligible debt service payments of \$119,000 to holders of the certificates of participation in fiscal year 2012-13; and understated the fund balance in the Special Gas Tax Improvement Fund by \$685 as of June 30, 2013, because the city incurred expenditures in excess of available funds.

In addition, we identified an observation relating to the city’s going concern.

Background

The State apportions funds monthly from the highway users tax account in the transportation tax fund to cities and counties for the construction, maintenance, and operation of local streets and roads. The highway users taxes derive from state taxes on the sale of motor vehicle fuels. In accordance with Article XIX of the California Constitution and Streets and Highways Code section 2101, a city must deposit all apportionments of highway users taxes in its Special Gas Tax Street Improvement Fund. A city must expend gas tax funds only for street-related purposes. We conducted our audit of the city’s Special Gas Tax Street Improvement Fund under the authority of Government Code section 12410.

Government Code section 14556.5 created a Traffic Congestion Relief Fund in the State Treasury for allocating funds quarterly to cities and counties for street or road maintenance, reconstruction, and storm damage repair. Cities must deposit funds received into the city account designated for the receipt of state funds allocated for transportation purposes. The city recorded its TCRF allocations in the Traffic Congestion Relief Fund. We conducted our audit of the city’s TCRF allocations under the authority of Revenue and Taxation Code section 7104.

Senate Bill 1266, Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006, was introduced as Proposition 1B and approved by the voters on November 7, 2006, for a variety of transportation priorities, including the maintenance and improvement of local transportation facilities. Proposition 1B funds transferred to cities and counties shall be deposited into an account that us designated for the receipt of state funds allocated for streets and roads. The city recorded its

Proposition 1B allocations in the Proposition 1B Fund. A city also is required to expend its allocations within four years following the end of the fiscal year which the allocation was made and to be expended in compliance with Government Code section 8879.23. We conducted our audit of the city's Proposition 1B Fund under the authority of Government Code Section 12410.

Objective, Scope, and Methodology

Our audit objective was to determine whether the city accounted for and expended the Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund, and Proposition 1B Fund in compliance with Article XIX of the California Constitution and the Streets and Highways Code. To meet the audit objective, we determined whether the city:

- Properly deposited highway users tax apportionments and other appropriate revenues in the Special Gas Tax Street Improvement Fund;
- Properly deposited TCRF allocations and Proposition 1B allocations into an account designated for the receipt of state funds allocated for transportation purposes;
- Expended funds exclusively for authorized street-related purposes; and
- Made available unexpended funds for future expenditures.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We did not audit the city's financial statements. We limited our audit scope to planning and performing the audit procedures necessary to obtain reasonable assurance that the city accounted for and expended the Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund, and Proposition 1B Fund in accordance with the requirements of the Streets and Highways Code and Revenue and Taxation Code section 7104 and Government Code section 8879.23. Accordingly, we examined transactions, on a test basis, to determine whether the city expended funds for street purposes. We considered the city's internal controls only to the extent necessary to plan the audit.

Conclusion

Our audit found that the City of Desert Hot Springs accounted for and expended its Special Gas Tax Street Improvement Fund in compliance with Article XIX of the California Constitution and the Streets and Highways Code for the period of July 1, 2008, through June 30, 2013, except as noted in Schedule 1 and described in the Findings and Recommendations section of this report. The findings required an adjustment of \$119,685 to the city's accounting records.

Our audit also found that the city accounted for and expended its Traffic Congestion Relief Fund in compliance with Article XIX of the California Constitution, the Streets and Highways Code, and Revenue and Taxation Code section 7104 for the period of July 1, 2008, through June 30, 2011.

In addition, our audit found that the city accounted for and expended its Proposition 1B allocations recorded in the Proposition 1B Fund in compliance with Government Code section 8879.23 for the period of July 1, 2008, through June 30, 2013.

Follow-Up on Prior Audit Findings

Our prior audit report, issued on July 3, 2009, disclosed no findings.

Views of Responsible Official

We issued a draft audit report on September 9, 2014, Martin Magaña, City Manager, responded by letter dated September 19, 2014, agreeing with the audit results with the exception of Finding 1. The city's response is included in this final audit report as an attachment.

Restricted Use

This report is intended for the information and use of the City of Desert Hot Springs' management and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of this report, which is a matter of public record.

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

November 18, 2014

**Schedule 1—
Reconciliation of Fund Balance
July 1, 2012, through June 30, 2013**

	Special Gas Tax Street Improvement Fund	
	Highway Users Tax Allocations ¹	Proposition 1B Fund ²
Beginning fund balance per city	\$ 63,832	\$ 249,995
Revenues	654,615	—
Total funds available	718,447	249,995
Expenditures	(719,132)	(249,995)
Ending fund balance per city	(685)	—
SCO adjustments: ³		
Finding 1—Unallowable charges for debt service	119,000	—
Finding 2—Deficit fund balance	685	—
Ending fund balance per audit	<u>\$ 119,000</u>	<u>\$ —</u>

¹ The city receives apportionments from the State highway users tax account, pursuant to Streets and Highways Code sections 2103, 2105, 2106, 2107, and 2107.5. The basis of the apportionments varies, but the money may be used for any street purpose. Streets and Highways Code section 2107.5 restricts apportionments to administration and engineering expenditures, except for cities with populations of fewer than 10,000 inhabitants. Those cities may use the funds for rights-of-way and for the construction of street systems. The audit period was July 1, 2008, through June 30, 2013; however, this schedule includes only the period of July 1, 2012, through June 30, 2013.

² Senate Bill 1266, Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond of 2006, introduced as Proposition 1B, provided funds for a variety of transportation priorities. The audit period was July 1, 2008, through June 30, 2013.

³ See the Findings and Recommendations section.

Findings and Recommendations

FINDING 1— Unallowable charges for debt service

In fiscal year (FY) 2012-13, the city charged the Special Gas Tax Street Improvement Fund \$119,000 for debt service payments related to Certificates of Participation, Series 12A (COPS). On February 1, 2012, the city entered into a trust agreement with the California Statewide Communities Development Authority and issued the COPS in the amount of \$5,925,000. The purpose of the COPS were to: 1) finance the design, acquisition, and construction of certain local roadway improvements and street resurfacing projects within the city, 2) fund a subaccount within the reserve fund for the COPS, and 3) pay the costs incurred in connection with the execution, sale, and delivery of the COPS. The COPS accrue interest at rates between 2% and 6%, payable semi-annually on June 1 and December 1, and mature through June 1, 2042. The debt service payments on the COPS are payable to the California Statewide Communities Development Authority solely from gas tax revenues and Measure A receipts.

There is no provision in the Streets and Highways Code for debt service payments of COPS. Therefore, all debt services payments relating to the COPS are an ineligible use of Gas Tax funds.

Street and Highway Code section 2107.4 states:

Not more than one-quarter of the funds allocated to a city or county from the Highway Users Tax Account in the Transportation Tax Fund for the construction of Streets therein may be used to make principal and interest payments on bonds issued for such construction, if the issuance of such bonds is authorized by a proposition approved by a majority of the votes cast thereon. The term of any such bonds shall not exceed 25 years.

Recommendation

The city should reimburse the Special Gas Tax Improvement Fund for the unallowable debt service payments totaling \$119,000 for FY 2012-13. In the future, the city should ensure that all debt service payments charged to the Special Gas Tax Improvement Fund are voter-approved bonds and not COPS. Additionally, the city should ensure that the proceeds from the bonds are used for street work and debt service payments and do not exceed one-quarter of the annual gas tax allocations, and that the terms of the bonds do not exceed 25 years.

City's Response

The city disagrees with this finding. See Attachment for the city's full response.

SCO’s Comments

The finding stands. Gas tax funds cannot be used to make payments on non-voter approved bonds or COPS debt even though it was used to finance a street improvement project. Under the agreement, the city makes installment payments in exchange for the JPA agreeing to construct certain roadway improvements. However, by the terms of the agreement, the only significant service the JPA is providing is the financing of the projects through the use of COPS. The JPA does not have any meaningful involvement in the projects.

Thus, the installment payments are used to pay the debt on non-voter approved COPS, not road construction. Moreover, the COP is a form of public debt financing or bond, and therefore, subject to the bond restrictions under the State Constitutional provisions and statutes applicable to the gas tax funds.

**FINDING 2—
Deficit fund balance-
gas tax**

The City of Desert Hot Springs’ Special Gas Tax Street Improvement Fund had a negative fund balance of \$685 as of June 30, 2013, because the city incurred expenditures in excess of available funds. By definition, each fund is a separate fiscal and accounting entity with a self-balancing set of accounts. As the Special Gas Tax Street Improvement Fund did not have sufficient funds to pay for expenditures, it became insolvent. This resulted in encumbering future Highway Users Tax (HUT) allocations to finance prior period expenditures.

Article 16 Section 18 of the California Constitution states, in part:

No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year. . . .

In addition, encumbering future highway apportionments to finance current-year and prior-year expenditures is contrary to generally accepted accounting principles.

Recommendation

The city should reimburse the Special Gas tax Street Improvement Fund by \$685. In the future, the city should establish procedures to ensure that expenditures do not exceed available funds and future HUT allocations are not encumbered to finance prior period expenditures.

City’s Response

Special Gas Tax Improvement Fund – Deficit Fund Balance. The deficit of \$685.00 was directly caused by an (audit) adjustment requested as a result of an audit of the Transportation Development Act (TDA) Article 3 Funds of the Bicycle and Pedestrian Facilities Program for the fiscal year ending June 30, 2013, disallowing an expenditure totaling \$1,890.96. City staff did present an argument during that audit

that the adjustment that was being requested should have been adjusted in the prior year audits when it occurred but the outcome was unsuccessful. If this adjustment had not been required, the Special Gas Tax Improvement Fund would have had a positive cash balance of approximately \$1,205.96. The City contends that the TDA auditors should have resolved this matter in the prior year's audits.

A transfer (reimbursement) from the General Fund to the Gas Tax Street Improvement Fund in the amount of \$685.00 was done in Fiscal Year 2013-14 making the Gas Tax Street Improvement Fund whole.

SCO's Comments

The city reimbursed the gas tax fund \$685 to eliminate the fund deficit.

OBSERVATION— Going concern

The independent auditor's report for FY 2012-13 states, in the Emphasis of Matters section, that the CPA prepared the accompanying financial statements assuming that the city will continue as a going concern. The CPA provides a detailed description of the city's financial condition in Note 20 of the financial statements, indicating that the city had a decrease of net position in the amount of \$11,283,350 from Government Activities, and that the General Fund has suffered significant reductions in the fund balance from operations. These conditions raised substantial doubt about the city's ability to continue as a going concern. Seeking a possible solution, the City Council authorized the placement of a measure on the June 2014 election ballot to raise an additional \$3.8 million in parcel tax revenues. However, on June 3, 2014, the voters rejected the measure. The State Controller's Office is concerned because the city's financial condition could negatively affect the Highway User Tax allocations as the city pools cash from all of its funds to maximize return on investments. The State Controller's Office's audit excluded FY 2013-14 because the city's books were still open for that year.

Recommendation

The city should take appropriate steps and develop an action plan to balance the General Fund budget and monitor cash flow closely.

City's Response

Observation Regarding the City as a Going Concern. Although the City is in a fiscal crisis it was able to adopt a Fiscal Year 2014-15 Budget with a \$10,000 reserve and cash flow for the first six months of the Fiscal Year 2014-15 totaling \$1.5 million. The City has also introduced new tax measures, the first is an increase to the sales tax by one percent and the second is a two part tax for Marijuana Cultivation and Marijuana Sale/Provision Tax and if approved it is estimated that the General Fund revenues could increase by \$1 million.

The City has taken additional steps to continue to monitor the General Fund cash on a weekly basis. City staff does report out all cash balances for the General Fund, restricted funds, special revenue funds, agency funds and Successor Agency funds to the City Council through the preparation of the monthly Treasurer's report.

SCO's Comments

The city has taken steps to improve the condition of the general fund.

**Attachment—
City’s Response to
Draft Audit Report**



City of Desert Hot Springs

65-950 Pierson Blvd. • Desert Hot Springs • CA • 92240

(760) 329-6411

www.cityofdhs.org

September 19, 2014

VIA CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Mr. Steven Mar
Chief, Local Government Audits Bureau
State Controller's Office
Division of Audits
Post Office Box 942850
Sacramento, California 94250-5874

Re: State Controller's Office Audit of City of Desert Hot Springs's
Special Gas Tax Street Improvement Fund and Traffic Congestion Relief Fund

Dear Mr. Mar:

Thank you for the opportunity to respond to the letter dated September 9, 2014 (the "Letter") from Mr. Jeffrey V. Brownfield, Chief, Division of Audits at the State Controller's Office (the "SCO"), to me, in my capacity as Acting City Manager of the City of Desert Hot Springs (the "City"). The Letter included a draft audit report prepared by the SCO (the "Draft Report") regarding the City's Special Gas Tax Street Improvement Fund (the "Gas Tax Fund"), Traffic Congestion Relief Fund and the Proposition 1B Fund. The Letter requested that the City submit any comments concerning the Draft Report within fifteen days after receipt of the Letter. The City received the Letter on September 16, 2014. This response is being submitted within such fifteen-day period.

According to the Draft Report, the SCO audit disclosed that the City was "in compliance with requirements, except that the city understated the fund balance in the Special Gas Tax Street Improvement Fund by \$119,685 as of June 30, 2013, because it charged ineligible debt service payments of \$119,000 to holders of the certificates of participation in fiscal year 2012-13; and understated the fund balance in the Special Gas Tax Improvement Fund by \$685 as of June 30, 2013, because the city incurred expenditures in excess of available funds."

Special Gas Tax Street Improvement Fund – Project Payments. In the SCO's opinion, the City charged \$119,000 as of June 30, 2013 in "ineligible debt service payments" payable to holders of the California Communities Transportation Revenue (Installment Sale) Certificates of Participation, Series 2012A (T.R.I.P. – Total Road Improvement Program), evidencing principal in the aggregate amount of \$5,925,000 (the "COPS"). In addition, the Draft Report stated in the "Finding and Recommendation" section:

There is no provision in the Streets and Highways Code for debt service payments of COPS. Therefore, all debt services payments relating to the COPS are an ineligible use of Gas Tax funds.

The Draft Report recommended that the City should reimburse the Special Gas Tax Improvement Fund for the unallowable debt service payments totaling \$119,000 for fiscal year 2012-13. Further, you advised that in the future, the City should ensure that all debt service payments charged to the Special Gas Tax Improvement Fund are voter-approved bonds and not COPS. Additionally, the City should ensure that the proceeds from the bonds are used for street work and debt service payments and do not exceed one-quarter of the annual gas tax allocations, and that the terms of the bonds do not exceed 25 years.

The City respectfully disagrees with the findings and recommendations set forth in the Draft Report and will respond to the concerns raised by the SCO in the Draft Report in detail below.

Special Gas Tax Improvement Fund - Deficit Fund Balance. The deficit of \$685.00 was directly caused by an (audit) adjustment requested as a result of an audit of the Transportation Development Act (TDA) Article 3 Funds of the Bicycle and Pedestrian Facilities Program for the fiscal year ending June 30, 2013 disallowing an expenditure totaling \$1,890.96. City staff did present an argument during that audit that the adjustment that was being requested should have been adjusted in the prior year audits when it occurred but the outcome was unsuccessful. If this adjustment had not been required, the Special Gas Tax Improvement Fund would have had a positive cash balance of approximately \$1,205.96. The City contends that the TDA auditors should have resolved this matter in the prior year's audits.

A transfer (reimbursement) from the General Fund to the Gas Tax Street Improvement Fund in the amount of \$685.00 was done in Fiscal Year 2013-14 making the Gas Tax Street Improvement Fund whole.

Observation Regarding the City as a Going Concern. Although the City is in a fiscal crisis it was able to adopt a Fiscal Year 2014-15 Budget with a \$10,000 reserve and cash flow for the first six months of the Fiscal Year 2014-15 totaling \$1.5 million. The City has also introduced new tax measures, the first is an increase to the sales tax by one percent and the second is a two part tax for Marijuana Cultivation and Marijuana Sale/Provision Tax and if approved it is estimated that the General Fund revenues could increase by \$1 million.

The City has taken additional steps to continue to monitor the General Fund cash on a weekly basis. City staff does report out all cash balances for the General Fund, restricted funds, special revenue funds, agency funds and Successor Agency funds to the City Council through the preparation of the monthly Treasurer's report.

Background

The COP financing structure utilized by the City can generally be described as the securitization of installment sale payments (“Installment Payments”) to be made by the City pursuant to a 2012 Installment Sale Agreement (the “2012 Installment Sale Agreement”), dated as of February 1, 2012, by and between the City and the California Statewide Communities Development Authority (a joint powers authority formed among various local agencies in the State of California, including the City) (the “JPA”). This securitization occurred through the execution and delivery by Wells Fargo Bank, National Association (the “Trustee”), acting as trustee under a Trust Agreement dated as of February 1, 2012 (the “Trust Agreement”), by and among the JPA, the Trustee and the City, of \$5,925,000 in principal amount of COPs on February 8, 2012. Approximately \$5,715,000 principal amount of COPs were allocable to the City’s now completed and pending road improvement projects described in Attachment A hereto (the “Project”).

The COPs were sold to the underwriter, which in turn publicly offered the COPs to investors. The proceeds from the sale of the COPs allocable to the City were paid to the Authority to acquire certain street and roadway improvements and resurfacing to be purchased by the City. Net proceeds also provided the funding of a reserve account and certain costs of issuance, as more particularly described in the Installment Sale Agreement; with the provision that amounts on deposit in the reserve account established under the Trust Agreement in excess of the reserve requirement and not applied to address unexpected debt service needs of the COPS would be applied to make interest payments or offset final installment payments. This securitization program is sometimes referred to as the “Total Road Improvement Program” or the “TRIP Program.”

By their terms, the COPs allocated to the City represent proportionate and undivided interests of the owners thereof in the Installment Payments to be made by the City to the JPA. The Installment Payments are made by the City from the City’s annual allocation of gas tax revenues provided under Sections 2104(d), (e) and (f), 2105, 2106 and 2107 of the California Streets & Highways Code (except revenues received by the City in accordance with Streets and Highways Code Section 2107.5) (the “Gas Tax Revenues”). All Gas Tax Revenues are deposited into the Gas Tax Fund.

The COPs do not constitute bonds or other indebtedness of the City, and the City did not rely on any authority under the California Constitution or the California Streets and Highways Code providing for the use of Gas Tax Revenues to pay the principal of and interest on bonds. The City’s Installment Payments do not constitute bonds or debt service on bonds. Rather, the Installment Payments constitute the purchase price for the Project, payable over time, which Project constitutes an authorized expenditure of Gas Tax Revenues under the California Constitution and the California Streets and Highways Code. The City acted using its authority to acquire or dispose of property in accord with the provisions of California Government Code Section 37350, which provides: “A city may purchase, lease, receive, hold, and enjoy real and personal property, and control and dispose of it for the common benefit.”

To ensure that the City, its legal counsel and investors could absolutely rely on the legality of this financing structure, the COP financing documents were submitted for legal validation pursuant to California Code of Civil Procedure Sections 860 *et seq.*, in the Riverside County Superior Court. The City received a favorable judgment on its validation action from the Superior Court on November 18, 2011.

The City notes that a number of other cities in the State of California have utilized gas tax financings that are substantially identical to the financing structure described above. To the City's knowledge, the financing structure in each of those financings was validated, as well.

Certificates of Participation Are Not Similar to Bonds

As of the date of execution and delivery of the COPs, then Section 5 (now Section 6, as further revised) of Article XIX of the California Constitution provided:

The Legislature may authorize up to 25 percent of the revenues available for expenditure by any city or county, or by the State, for the purposes specified in subdivision (a) of Section 1 of [Article XIX] to be pledged or used for the payment of principal and interest on voter-approved bonds issued for such purposes.

California Streets and Highways Code Section 2107.4 contains similar proscriptions with respect to the issuance of bonds secured by an issuer's gas tax revenues – *i.e.*, that the bonds must be voter-approved, the longest maturity cannot exceed 25 years, and not more than 25% of an issuer's gas tax revenues can be used to pay principal and interest on such bonds.

The City's pledge of all of its Gas Tax Revenues to secure Installment Payments under the Installment Sale Agreement does not violate Section 6 of Article XIX of the California Constitution or California Streets and Highways Code Section 2107.4 because those sections, by their terms, apply only to pledges securing the payment on "bonds." The City instead pledged its Gas Tax Revenues to make Installment Payments as the purchase price for the Project acquired with the proceeds of the COPs, and not to make principal and interest payments with respect to bonds.

Certificates of participation are documents evidencing the holder's undivided proportionate interest in certain payments that will be made pursuant to contract; in this case, the Installment Payments under the Installment Sale Agreement. Unlike bonds, the COPs are not evidences of indebtedness and do not represent a separate debt or obligation of the City apart from the limited contractual obligation created by the Installment Sale Agreement. In short, no bonds were issued with respect to the City's acquisition of the Project. Accordingly, the City's pledge of Gas Tax Revenues to acquire the Project does not violate Section 6 of Article XIX of the California Constitution or California Streets and Highways Code Section 2107.4. In that regard, it is well established in California public finance law in a variety of different contexts that certificates of participation in leases and installment sale agreements are not "bonds."

For example, the California Debt Issuance Primer (the “Primer”), published by the California Debt and Investment Advisory Commission (the Chair of which is the State Treasurer), notes the distinction between certificates of participation and bonds. The section entitled “Policy Considerations” in the chapter of the Primer entitled “Financing Leases and Certificates of Participation” begins with:

Historically, financing leases and COPs have been used when bond financing was determined to be unavailable or undesirable for a variety of reasons, including:

- **The election requirements of the California Constitution, the relevant statutes, or a city charter could not be met**
- **The facility to be financed generated no revenues on its own** (e.g. a city administrative office building) and local general obligation bonds were not permitted (1978 through 1986)
- A statutory interest rate limitation applicable to bonds was below the market rate
- A statute authorizing bonds required a competitive sale in a market in which negotiated sale was more appropriate
- **Other restrictive conditions on the use of bond proceeds or the procedures of issuance were contained in the bond statute**

[Emphasis added.]

In addition, the section entitled “Legal Authority” in the same chapter of the Primer begins with:

In analyzing a tax-exempt lease financing, it is important to remember that **the public agency is using its authority to acquire or dispose of property, rather than its authority to incur debt.** While the terms “tax-exempt lease” or “financing lease” will be used herein, the tax-exempt obligation may be structured as an installment purchase agreement, installment sale agreement, or lease-purchase agreement [Emphasis added.]

While certificate of participation financings have long been utilized by California local agencies, the State itself has also participated in such financings. For one example, please see the \$126,165,101.19 Certificates of Participation Series 1991A and 1991B, evidencing proportionate, undivided interests of the holders thereof in rental payments to be made by the State of California, through the Department of Transportation (the “Department”). The Official Statement for the State’s financing included the following disclaimer:

Neither the Certificates nor the obligation of the Department to make Rental Payments under the Facility Lease represent or constitute a debt of the Department, the State or the [East Bay State Building] Authority within the meaning of any constitutional or statutory limitation or a pledge of the faith and credit of the State, any political subdivision thereof, the Authority or the Department.

Substantially similar disclaimers are used in all other certificate of participation financings, including the City's COPs. For example, the City's disclaimer in the Official Statement read as follows:

The obligation of [the City] to make Installment Payments under its 2012 Installment Sale Agreement is a special obligation of [the City] payable solely from applicable gas tax revenues and does not constitute a debt of [the City], any other Local Agency, the Authority, the State of California (the "State"), or any political subdivision of the State within the meaning of any constitutional or statutory debt limitation or restriction, and does not constitute an obligation for which the [City], any other Local Agency, the State, or any political subdivision of the State is obligated to levy or pledge any form of taxation or for which the [City], any other Local Agency, the State, or any political subdivision of the State has levied or pledged any form of taxation.

In summary, certificates of participation are not treated as "similar to bonds" by public finance professionals, California courts, the municipal marketplace, and even the State of California itself. Unlike bonds, certificates of participation are not debt obligations. The City's pledge of all of its Gas Tax Revenues to secure Installment Payments does not constitute the payment of debt service and does not violate Section 6 of Article XIX of the California Constitution or California Streets and Highways Code Section 2107.4.

No Voter Approval of the COPs or the Installment Sale Agreement Was Required

The Draft Report noted that the City did not obtain voter approval of the COPs. As shown in the foregoing discussion, certificates of participation do not constitute debt obligations for which voter approval is required. The following discussion clarifies that the Installment Sale Agreement and the Installment Payments made there under do not constitute obligations that require prior voter approval, as well.

Section 18(a) of Article XVI of the California Constitution (the "Debt Limitation Provision") provides in relevant part as follows:

No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters of the public entity voting at an election to be held for that purpose....

The Debt Limitation Provision was adopted to create a “pay-as-you-go” approach to municipal finance and to put a stop to local governments incurring indebtedness far in excess of their income and revenue for the year in which such debt was incurred, which created a floating indebtedness requiring payment out of income and revenue of future years. However, certain exceptions to the voter-approval requirement of Section 18 of Article XVI of the California Constitution also exist. One such exception – the “Special Fund Exception” – removes the Installment Sale Agreement from such voter-approval requirements. The Special Fund Exception applies to the City’s COP financing.

Under the Special Fund Exception, the Debt Limitation Provision is not violated by an Installment Sale Agreement that provides that installment payments are payable from a “special fund,” rather than from a general fund. (See, for example, *Rider v. City of San Diego*, 18 Cal.4th 1035, 1046 (1998).) In order for a fund to qualify as a special fund, such fund must not be maintained from general funds or property tax revenues of the governmental entity making the payments.

The Installment Sale Agreement provides that Installment Payments are payable solely from Gas Tax Revenues, all of which must be deposited into the Gas Tax Fund, a special fund of the City. The Gas Tax Fund is funded exclusively from Gas Tax Revenues. Neither the City’s General Fund nor property tax revenues are pledged to make any such payments.

The pledge of Gas Tax Revenues to Make Installment Payments to Finance the Project Is Consistent with the Purposes of California Government Code Section 37350 and Section 2 of Article XIX of the California Constitution

The Draft Report states: “There is no provision in the Streets and Highways Code for debt service payments of COPs.” The absence of such a provision is irrelevant, as the City did not structure the COP financing pursuant to the financing provisions of the California Streets and Highways Code or based upon its authority to incur debt. Instead, the City executed and delivered the Installment Sale Agreement and pledged its Gas Tax Revenues to make Installment Payments to purchase the Project over time pursuant to its authority to acquire or dispose of property. The actions taken by the City are in accord with the provisions of California Government Code Section 37350, which provides: “A city may purchase, lease, receive, hold, and enjoy real and personal property, and control and dispose of it for the common benefit.”

As of the date of execution and delivery of the COPs, then Section 1 (now Section 2, as further revised) of Article XIX of the California Constitution provided in relevant part:

Revenues from taxes imposed by the State on motor vehicle fuels for use in motor vehicles upon public streets and highways, over and above the costs of collection and any refunds authorized by law, shall be used for the following purposes:

(a) The research, planning, construction, improvement, maintenance, and operation of public streets and highways (and their related public facilities for nonmotorized traffic), including the mitigation of their environmental effects, the payment for property taken or damaged for such purposes, and the administrative costs necessarily incurred in the foregoing purposes.

The City's pledge of Gas Tax Revenues to make Installment Payments for the purpose of acquiring the Project is consistent with the purposes set forth above. The Project consists entirely of the construction and improvement of public streets located within the City. The Gas Tax Revenues are being used by the City to make Installment Payments directly with respect to the acquisition of such public street improvements.

A principal requirement of the TRIP Program, specifically addressed in the legal structure, is limiting the application of Gas Tax Revenues to installment payments directly related to projects eligible for funding under the Highway Users Tax Program only. In that regard, the City notes the following points:

(1) Gas Tax Revenues are not available and are not pledged to make Installment Payments if the Project is not a qualified project. Thus, the Project is comprised of facilities that are eligible for expenditure of Gas Tax Revenues under applicable law. See discussion of Section 5.04 of the Installment Sale Agreement below.

(2) Supporting the required use of COP proceeds to construct only eligible Projects is the Section 5.04 covenant with respect to the maintenance of Gas Tax Revenues. The City must take all actions necessary to maintain its ability to receive Gas Tax Revenues; in particular, the City must satisfy the audit and review requirements of the State Controller. In that regard, this financing structure compels the City to comply in all respects with the State Controller's audit and review process.

There should be no confusion about whether the City had in mind the acquisition and construction of a Project expected to be approved by the State Controller. Efforts were made to assure that the Project met such requirements. In that regard, the Installment Sale Agreement was express in its recognition of the State Controller's audit procedures and guidelines. Pursuant to Section 5.04 of the Installment Sale Agreement - Maintenance of Revenues, the City is required to:

[U]se its best efforts to comply with all provisions of law and any regulations issued there under relating to the Revenues, including, but not limited to the Measure A Ordinance, Sections 2119 and 2151 through 2155 of the California Streets and Highways Code and Sections 65089.3 and 65089.4 of the California Government Code relating to conformance with the congestion management program relating to the [City], and will take any and all reasonable actions required in order to maintain the [City's] ability to receive the Revenues and apply the same as provided herein; [subject to certain reasonableness limitations as set forth in the Installment Sale Agreement.]

As to the clearly direct expenditures for projects, the principal components of the Installment Payments under the Installment Sale Agreement apply directly to projects that have been approved by the SCO under its audit procedures. A question may arise, however, as to whether the City's use of Gas Tax Revenues to pay the interest components of the Installment Payments is authorized as an indirect expenditure of Gas Tax Revenues. The California Court of Appeals has held that the indirect expenditure of motor vehicle fuel tax revenues for legitimate road and highway purposes is valid under Article XIX of the California Constitution. (See *City of Costa Mesa v. Connell*, 74 Cal.App.4th 188, 193 (1999).) Interest expense (in this case, the interest components of the Installment Payments under the Installment Sale Agreement) is sometimes considered a direct expense and sometimes an indirect expense of a project, but in either case it is an expense made with respect to the Project. Thus, the interest component of each the Installment Payment is an authorized expenditure of Gas Tax Revenues.

The Use of Gas Tax Revenues to Make Installment Payments under the Installment Sale Agreement Was Validated by Superior Court Judgment and is Incontestable

Finally, the City notes that the SCO was provided opportunity (as further described below) in 2011 to question or contest the City's proposed pledge of Gas Tax Revenues to make Installment Payments prior to the City's execution and delivery of the Installment Sale Agreement. In addition, due to the favorable judgment received by the City from the Riverside County Superior Court with respect to the City's validation action, the SCO is now precluded from contesting the matter further.

As a general matter, bond counsel will turn to the Validation Statute, California Code of Civil Procedure Sections 860 *et seq.*, to confirm the validity of legal questions arising in connection with financial obligations and contracts. By practice and rules of professional conduct, bond counsel would only validate propositions that are reasonably thought to be legally correct, as was the case here. In that regard, bond counsel validate such propositions primarily because the standard in the public finance industry is to require the delivery of an "unqualified" legal opinion as to the validity of bonds and contracts, not a "reasoned" opinion as is the case in other transactional practices.

The City commenced a validation action on August 29, 2011 in the Riverside County Superior Court to confirm the validity of several legal issues that arose in connection with the City's proposed pledge of Gas Tax Revenues as the sole source of funding for the Installment Payments and to obtain absolute certainty of the financing's legality for those participating in the transaction, including purchasers of the COPs. Jurisdiction of the matter was obtained pursuant to Section 861 of the California Code of Civil Procedure, and no person, including the SCO, responded to the Complaint for Validation.

As noted above, the City received a favorable judgment on its validation action from the Riverside County Superior Court on November 18, 2011. As part of its judgment, the Superior Court ordered and decreed, among other things, that:

1. The City has complied with this Court's Order providing for publication and service of the Summons (the "Order for Publication"). Jurisdiction over all persons interested in the subject matter of this action was established by (a) the publication of the Summons in THE DESERT SUN once each week for three successive weeks pursuant to Government Code Section 6063; and (b) posting a copy of the Summons in two public locations within the City, all in accordance with the Order for Publication and Civil Procedure Code Section 860 *et seq.* (the "Validation Statute"). No interested person filed an answer or otherwise responded to the Complaint within the time required to do so as specified in the Summons and the Court's Order for Publication. Entry of default was warranted from and after October 17, 2011.

2. The notice procedures provided under the Validation Statute, and the notice provided by the City in this action as described above, provided due and proper notice to all persons interested in this action, and pursuant to such notice, this Court has jurisdiction over all persons and the subject matter of this action.

3. This action is properly brought under Government Code Section 53511 and the Validation Statute in the Superior Court for the County of Riverside, and is entitled to expedited treatment under Civil Procedure Code Section 867.

4. All proceedings by and for the City in connection with the City Resolution, the Trust Agreement, the Installment Sale Agreement, the Certificate Purchase Agreement, the Contracts and the Certificates, Additional Contracts or agreements authorized or contemplated by the City, all as defined in the accompanying memorandum of points and authorities, were, are, and will be in conformity with the applicable provisions of all laws and enactments at any time in force or controlling upon such proceedings, whether imposed by law, constitution, statute or ordinance, whether federal or state, and were, are and will be fully in conformity with all applicable requirements of all regulatory bodies, agencies or officials having or asserting authority over said proceedings or any part thereof.

5. All conditions, things and acts required by law to exist, happen or be performed precedent to the adoption of the City Resolution, and the terms and conditions thereof, including the authorization for the execution and delivery of the Trust Agreement, the Installment Sale Agreement, the Certificate Purchase Agreement, the Certificates and any other related contracts, Additional Contracts or agreements authorized or contemplated by the City, have existed, happened and been performed in the time, form and manner required by law.

6. The City has the authority under the California Constitution and California law to (i) execute and deliver the Trust Agreement, the Installment Sale Agreement, the Certificate Purchase Agreement and the Certificates, and any related contracts, Additional Contracts, or agreements; (ii) apply the proceeds of the Certificates to the financing of the Project; (iii) commit and apply the Gas Tax Revenues and Measure A Revenues to the payment of the installment payments pursuant to the Installment Sale Agreement and the Trust Agreement; and (iv) so long as the City is not in default under the Installment Sale Agreement, execute and deliver Contracts and commit and apply Gas Tax Revenues and Measure A Revenues on a parity with the payments under and consistent with the terms of the Installment Sale Agreement.

7. Upon execution and delivery thereof, the Trust Agreement, the Installment Sale Agreement, the Certificate Purchase Agreement, the Certificates, and any and all contracts, Additional Contracts, and agreements executed and delivered in connection therewith will be valid, legal and binding obligations in accordance with their terms.

8. Pursuant to Code of Civil Procedure Section 870, this judgment binds and permanently enjoins and restrains all persons from the institution of any action or proceeding challenging, *inter alia*, the validity of the City Resolution, the Trust Agreement, the Installment Sale Agreement, the Certificate Purchase Agreement, the Certificates or any related contracts, Additional Contracts and agreements, or any matters herein adjudicated or which at this time could have been adjudicated in this action.

The validation statute provides strong protection for a public agency transaction that has been validated by a validation judgment. Section 870(a) of the California Code of Civil Procedure provides:

The judgment, if no appeal is taken, or if taken and the judgment is affirmed, shall, notwithstanding any other provision of law including, without limitation, Sections 473 and 473.5, thereupon become and thereafter be forever binding and conclusive, as to all matters therein adjudicated or which at that time could have been adjudicated, against the agency and against all other persons, and the judgment shall permanently enjoin the institution by any person of any action or proceeding raising any issue as to which the judgment is binding and conclusive.

Because a validation action is an *in rem* action, the judgment conclusively binds the public agency and all other persons. Section 870 of the California Code of Civil Procedure precludes subsequent challenges asserting any issue that was or could have been adjudicated in the validation action, including constitutional issues. See *Friedland v. City of Long Beach*, 62 Cal.App.4th 835 (1998) at 846-47 holding: “We hold that as to matters which have been or which could have been adjudicated in a validation action, such matters – including Constitutional challenges – must be raised within the statutory limitations period in section 860 *et seq.* or they are waived.”

In light of the judgment obtained by the City in its validation action and the SCO’s failure to file a timely appeal, the SCO is not permitted to challenge the City’s pledge or continued use of Gas Tax Revenues as described herein.

Conclusion

For all of the foregoing reasons, the City asserts, and respectfully requests your reconsideration, that (i) the City's pledge and use of Gas Tax Revenues to the make Installment Payments under the Installment Sale Agreement is valid, lawful, and binding as to all parties, (ii) the SCO is precluded from challenging the City's pledge and continued use of Gas Tax Revenues as described herein, and (iii) the SCO's determinations and recommendations set forth in the Draft Report are unfounded and should be retracted. The City would appreciate the SCO providing written confirmation of its agreement with the City regarding these matters and delivering its unqualified, approving final audit report to the City at the SCO's earliest convenience.

Please do not hesitate to contact the undersigned if you have any questions or would like to discuss further any of the matters addressed in this letter.

Respectfully submitted,

CITY OF DESERT HOT SPRINGS

By: *Martin Magana*
Martin Magana, City Manager

ATTACHMENT A

CITY OF DESERT HOT SPRINGS – FINANCED PROJECT LIST

Project Name: 2012 Street Rehabilitation Project - Scope of work: Roadway resurface/rehabilitation of various road segments throughout the City, selected based on pavement ratings determined through the City’s Pavement Management Plan. The scope of work included the pulverization of existing asphalt and installation of new asphalt concrete, the grind and overlay of asphalt concrete, and the removal and replacement of cross gutters, curbs, and curb and gutters where necessary. Total Project Funding = \$5,700,000.00

<p>Completed Projects – Construction Completed November 2012. (The following road segments were completed on November 2012): -Ironwood Dr - Verbena Dr to Palm Dr -Ironwood Dr - Caliente Dr to West Dr -Ocotillo Rd - Hacienda Dr to Mesquite Ave -Richard Way – Ocotillo Rd to End -Mesquite Ave – Pierson Blvd to San Ardo Rd -3rd St – Palm Dr to alley -Upland Way – 3rd St to Vista Pl -4th St – Cresent Dr to Terrace Way -Cresent Dr – 4th ST to End -Terrace Way – Ambrosio Dr to End -Pomelo Dr – Pasatiempo Dr to San Ardo Rd -Pasatiempo Dr – Ambroio Dr to Foxdale Dr -San Ardo Rd – Ambrosio Dr to Bernardo Way -Smokewood Cir – San Ardo Rd to End -Bernardo Way – San Ardo Rd to End -Yucca Dr – Verbena Dr to Palm Dr -12th St – Palm Dr to Santa Cruz Rd -San Pablo Rd – 8th St to 12th St -San Miguel Rd – 8th St to San Juan Rd -Via Real – Desert View Rd to Pierson Blvd -Cactus Dr – Two Bunch Palms Trail to Hacienda Ave -Mountain View Rd – Whitney Court – Via Domingo -Hacienda Ave – Club Circle Dr to Calle Amapola</p> <p>Total Cost: \$4,700,000</p>	<p>Proposed Projects – To be completed by end of Fiscal Year 2014-15. (The following road segments are planned to be completed in FY 2014-15): -6th St – Palm Dr to Ocotillo -Hacienda Ave – MC Carger to Avenida La Vista -Ironwood Dr – West Dr to Cholla Dr -Verbena Dr – Ironwood Ave to Two Bunch Palms -Verbena Dr – San Rafael to Mission Lakes Blvd</p> <p>Total Cost: \$1,000,000</p>
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