Office of the President
July 3, 2003

TO MEMBERS OF THE COMMITTEE ON FINANCE:

ITEM FOR ACTION

For Meeting of July 16, 2003

AUTHORIZATION TO ESTABLISH INDENTURE FOR GENERAL REVENUE BONDS TO FINANCE AND REFINANCE DEBT FOR UC PROJECTS

The President recommends that:

(1) The Committee on Finance recommend to The Regents that the President be authorized to establish a new indenture to refinance existing debt of the University of California and to finance debt for new University projects, subject to the following:

a. General Revenues of the University of California be used to secure and repay debt service on bonds issued under the indenture, provided that the following shall be excluded from General Revenues:

i. Appropriations from the State of California, except as permitted under Section 28 of the State Budget Act or as authorized by other legislative action; and

ii. Monies which are restricted as to expenditure by granting agency, donor, or University designation.

b. Bonds may be issued as fixed rate bonds or variable rate bonds, or as taxable or tax-exempt bonds or with other such terms and conditions as may be determined in supplemental indentures.

(2) The President be authorized, where appropriate and subject to the concurrence of the Chairman of the Board and the Chairman of the Committee on Finance, to approve interest rate swaps to achieve a lower synthetic fixed borrowing rate for the bonds issued or to otherwise achieve the University's desired interest rate risk profile.

(3) Officers of The Regents be authorized to execute all documents necessary, including the indenture and supplemental indentures, in connection with the above.

BACKGROUND

This item requests the approval of a new General Revenue bond indenture and approval of the use of General Revenues of the University (as defined in the indenture and described in Attachment 1 below) in connection with the refinancing of the existing portfolio of outstanding University revenue bonds and certificates of participation, as well as for the issuance of new bonds for University projects. The item also authorizes the President, with the concurrence of the

Chairman of the Board and the Chairman of the Committee on Finance, to employ interest rate swaps to lower the fixed interest rate risk profile.

Debt Restructuring

Last Fall, the University selected, in a competitive process, an investment banking firm, Lehman Brothers, to perform an analysis of the debt capacity of the University, undertake an analysis of the University's debt structure, and assist with a debt strategy and recommendation of debt restructuring based on market evaluation and the University's debt position. The goal is to position the University to take advantage of its varied and strong revenue sources, to increase the debt capacity of the University in this period of rapid enrollment growth, and to take advantage of historic low interest rates.

A steering committee and campus advisory groups were established to work with Lehman on these analyses. In addition to participation by the staff from the Office of the President (OP) and the Treasurer's Office, each campus was represented, as were the academic Medical Centers. Lehman and OP staff visited each campus to review projected capital needs and alternative financing options of the campuses and Medical Centers. The FY 2003-FY 2007 Non-State Capital Program and the November, 2002 Housing Study, which have both been previously presented to The Regents, served as the basis for understanding our long-term capital needs.

Originally, it was anticipated that comprehensive recommendations for any changes in debt policies would be submitted to The Regents at the conclusion of this review. The substantial decline in interest rates, however, provides an opportunity for significant savings through refinancing at this time. Therefore, the first phase of this review which addresses issues related to a refinancing is being presented now.

The first phase of the analysis examines opportunities to increase our borrowing capacity and to lower the cost of servicing debt. In the second phase of the analysis, other debt and financing issues will be explored, including asset-liability management and financing structures for third-party financings.

General Revenue Financing

Currently the University pledges specific revenue sources to secure and repay its existing debt (i.e., different revenues for different types of debt). It is recommended that the University consolidate and broaden the sources of the revenues used to secure and repay most refinanced and new debt. This broader pledge (of General Revenues) would more appropriately and effectively demonstrate the breadth and depth of resources that the University has available to service its debt and provide expanded debt capacity. It would also facilitate the establishment of a new bond indenture that provides more financing options and flexibility to the University.

New "Senior" Bond Indenture

The task force analysis recommends the creation of a new General Revenue bond indenture that would serve as the primary financing vehicle for University debt (with the exception of debt for the Medical Centers and new financing for auxiliary activities). The University would no longer issue additional series of bonds under the 1991 Multiple

Purpose Projects indenture, which had served as the University's primary financing vehicle for the last decade.

The General Revenue bond indenture would make four key changes:

1. Establish flexibility as to the principal payment date,

2. Allow interest to be paid on any date, which would facilitate the use of new variable rate borrowing products,

3. Expand the pool of funds available to pay the debt service on the bonds and relax debt covenant restrictions to reflect current market practices and the financial strength of the University, and

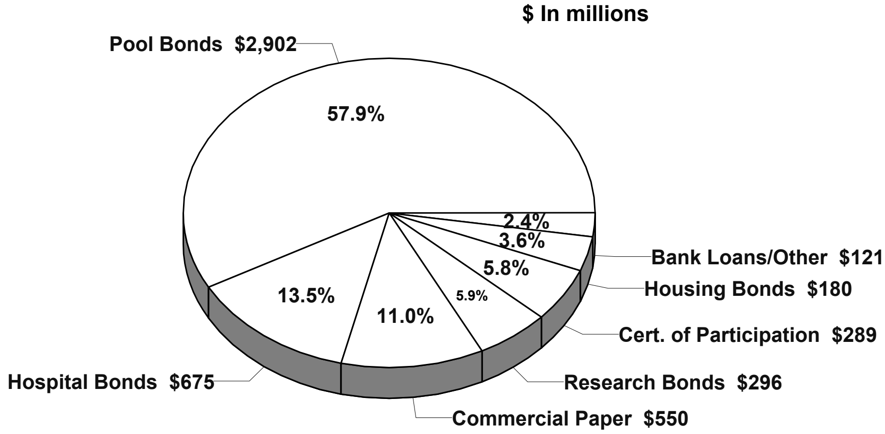
4. Remove the need to fund a debt service reserve fund, thereby saving at least $1 million in surety bond costs for the first debt issuance planned for this summer 2003.

The General Revenue bond indenture would become the primary vehicle for financing University projects. While new auxiliary service projects could be funded through this indenture, the University is exploring other alternatives for these projects. Each Medical Center would continue to pledge its respective revenues for its debt funded projects. The Commercial Paper Program would continue to provide interim construction and acquisition financing at the lowest interest rates, as well as financing for intergovernmental transfers required for supplemental funding for the University's Medical Centers.

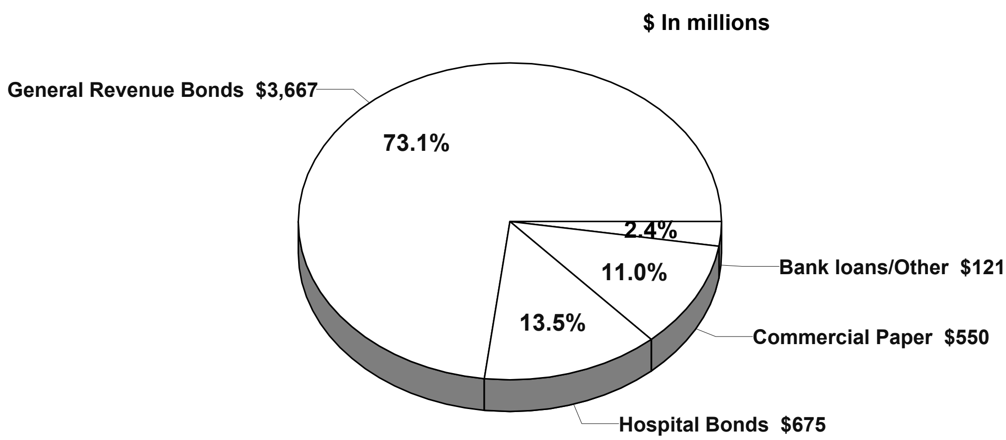
<u>Debt Structure</u>

There is currently outstanding approximately $4.5 billion of University revenue bonds and certificates of participation, with a weighted average interest rate of 5%. Not included in this total is the University's Commercial Paper Program, which has $550 million authorized and outstanding at an approximately 1% interest rate, and approximately $1.2 billion in State of California State Public Works Board ("SPWB") lease revenue bonds.

The following pie chart displays University issued debt totaling $5 billion outstanding as of June 30, 2003 (including Commercial Paper but excluding State SPWB bonds):



The specific revenues to be included in the "General Revenues" are listed in Attachment 1. Assuming full restructuring under the General Revenue bond indenture, the University's debt profile for the currently outstanding debt would be simplified as follows:



Project approvals

All projects to be financed would continue to be individually reviewed and approved by The Regents. For auxiliary enterprise projects, such as student housing and parking, the auxiliary would continue to demonstrate that enterprise revenues are sufficient to pay for operating expenses and debt service, with a required surplus for major maintenance and debt service cushion. Education and General projects for the core programs would benefit from a broader revenue pledge, but campuses would also need to demonstrate the ability to generate sufficient revenues from core activities to pay debt service and provide a debt service cushion.

Interest Rate Swaps

It is recommended that the General Revenue bond indenture include the flexibility to employ interest rate swaps when appropriate. Swaps would be employed only upon the further approvals of the Chairman of the Board and the Chairman of the Committee on Finance. Analyses would be provided which would demonstrate the risks and rewards of the particular type of swap being recommended.

Interest rate swaps are contracts to exchange the payment of interest based on a notional amount, generally tied to a bond issuance. In the case of a floating-to-fixed interest rate swap, the University would pay a fixed interest rate which may often be 30 – 100 basis points lower than could otherwise be achieved through the issuance of fixed rate bonds of the same maturity, while receiving a variable rate payment from a counterparty. As appropriate, the University could enter into fixed-to-floating rate swaps to convert fixed rate bond payments into a lower floating rate payment. The risks associated with these transactions need to be carefully assessed relative to potential savings.

The University employed an interest rate swap for the UC Davis Medical Center refinancing in March, 2003. This structure enabled the UC Davis Medical Center to reduce its interest rate by approximately 1.36% in comparison to a traditional fixed rate transaction.

Current Market Opportunities

The proposed General Revenue bond debt strategy recommends the refinancing of existing University revenue bonds when they can be refinanced economically into the new General Revenue bond indenture. It is contemplated that the first issue under the new indenture would refund an aggregate amount of approximately $1.2 billon of existing UC debt, comprised of the UC Housing System bonds, series A of the Research Revenue bonds, the UCLA chiller/cogeneration certificates of participation, series C of the 1989 Multiple Purpose Projects and series B and C of the 1991 Multiple Purpose Projects. Additionally, the first issuance would likely include approximately $170 million of new projects, permanently financing projects from the Commercial Paper Program.

Over time, the remaining bonds, 1991 Multiple Purpose Project bonds ($1.7 billion), Research Revenue bonds ($261 million), and other certificates of participation ($120 million), will be candidates to be refunded into the new General Revenue bond indenture.

Interest rate markets are at historic lows. Refinancing the proposed existing bonds under the General Revenue bond indenture would result in estimated present value debt service savings over the life of the instruments of approximately $84 million, based on current rates and assumptions, due to lower interest rates and also extending the final maturity of bonds for many projects to the useful economic life of these projects. No interest rate swaps are contemplated for this first series of bond refundings.

Bond Ratings

The bond ratings for University Multiple Purpose Project bonds are currently in the double "A" category (Standard & Poor's and Moody's Investors Service), despite the financial difficulties of the State of California. It is anticipated that the ratings for the General Revenue bonds will also be in the double "A" category. Rating agencies have placed State of California bonds on "credit watch" because of the state's failure to adopt a prudent state budget. The agencies have also placed UC ratings on credit watch in light of the state financial issues. It is anticipated that the state will adopt a prudent state budget and that the University will be able to proceed as planned. A failure of the state to act in a timely manner could lower or eliminate anticipated savings and delay or preclude this restructure.

Summary

The pledge of General Revenues of the University under a new General Revenue bond indenture will expand the revenues that can be pledged for debt service. This expansion is critical to enabling the issuance of additional debt for capital projects to support the enrollment expansion, the development of academic programs, and the repair and replacement of critical campus infrastructure. Individual projects would continue to be brought to the Board for approval of external financing. The new General Revenue bond indenture would provide greater flexibility as the University proceeds to refinance its existing debt to reduce debt service costs and to finance new project debt.

(Attachment Two)

Description of General Revenues of the University

General Revenues of the University of California would include the following operating and non-operating revenues of the University on the statement of revenues, expenses and changes in net assets in the University's Annual Financial Report, using generally accepted accounting principles and accounting principles consistently applied within the University:

- Student tuition and fees;
- Indirect cost recovery from contracts and grants;
- Sales and service revenues from educational activities;
- Other operating revenues;
- Cash receipts of private gifts;
- Investment income (primarily the Short Term Investment Pool ["STIP"], but also including unrestricted endowment income and net securities lending income); and
- Other revenues designated by the University from time to time.

Excluded from General Revenues are:

- State appropriations (except for monies associated with those projects, primarily cogeneration and other energy saving projects, which have received specific authorization to use state appropriations for debt service through a process identified in Section 28 of the State Budget Act or otherwise authorized by the Legislature);

- Monies restricted by granting agency (for example, funding for the majority of the direct cost of research, including direct cost portion of contracts and grants, funds for the Department of Energy Laboratories, restricted gifts, and the interest income on restricted funds, among others);

- Other revenues which may be restricted by the University from time to time (for example, revenues of academic medical centers, DOE Lab management fees, etc.).

The University would retain the flexibility to add some or all of these excluded revenues in the future.

Attachment 2 displays the proposed General Revenues of nearly $4 billion available for debt service based on the statement of revenues, expenses and changes in net assets in the University's June 30, 2002 Annual Financial Report.