

501-B

Office of the President

TO THE MEMBERS OF THE COMMITTEE ON FINANCE:

ACTION ITEM

For Meeting of May 18, 2006

Action by Consent

- B. AUTHORIZATION TO ESTABLISH INDENTURE FOR ACADEMIC MEDICAL CENTER POOLED REVENUE BONDS TO FINANCE AND REFINANCE DEBT FOR THE UC MEDICAL CENTERS AND, SUBJECT TO THE CONCURRENCE OF THE CHAIRMAN OF THE BOARD AND THE CHAIR OF THE COMMITTEE ON FINANCE, TO EXECUTE INTEREST RATE SWAPS WHERE APPROPRIATE TO REDUCE INTEREST RATE EXPENSE OF SUCH BONDS**

EXECUTIVE SUMMARY

The President recommends approval of a new Academic Medical Center Pooled Revenue Bond Indenture and the pooling of the revenues of the University of California's medical centers to be pledged for debt repayment, regardless of which medical center uses the loan or bond proceeds. This indenture will be developed to provide the same financing flexibility for the medical centers currently enjoyed by core campus and auxiliary units. It will yield a financial benefit as higher bond ratings increase debt capacity for the medical centers as a group, reduce borrowing rates and other financing costs, and increase access to the financial markets.

- Issues:
- Establishes principles for establishing the University of California Medical Center Pooled Financing Credit, including principles on governance, financial responsibility, debt capacity, capital approval process and debt targets, financial reporting, and the modification of the principles.
 - With the concurrence of the Chairman of the Board and the Chair of the Committee on Finance, authorizes the President to employ interest rate swaps to reduce the interest expense otherwise achievable in the market on certain bond issues.

RECOMMENDATION

The President recommends that:

- (1) The President be authorized to establish an indenture to refinance existing debt of the University of California medical centers and to finance and refinance debt for new medical center projects, subject to the following:
 - a. Revenues of all UC medical centers be pooled and used to pay debt service on bonds issued under the indenture, regardless of which medical center uses proceeds of borrowing.
 - b. Bonds may be issued as fixed rate bonds or variable rate bonds, or as taxable or tax-exempt bonds or with such other 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 Chair of the Committee on Finance, to execute interest rate swaps based on receiving either a percentage of the Bond Market Association Tax-exempt Index, the taxable LIBOR index, or similar indices to achieve a lower synthetic fixed rate for the bond issue or to otherwise achieve the desired interest rate risk profile.
- (3) Officers of The Regents be authorized to execute all documents, including the indenture, necessary in connection with the above.

BACKGROUND

Approval is requested for a new Academic Medical Center Pooled Revenue Bond Indenture (AMC Indenture) and the pooling of the revenues of the University of California's medical centers to be pledged for debt repayment, regardless of which medical center uses the loan or bond proceeds. Internal management procedures requiring each medical center and its campus to be financially responsible for the debt service for bond proceeds used for its facilities will remain in effect. The pooled medical center financing structure is expected to improve the bond rating for the medical centers above the bond rating achievable by any single medical center. This will yield a financial benefit as higher bond ratings increase debt capacity for the medical centers as a group, reduce borrowing rates and other financing costs, and increase access to the financial markets.

Under this proposal, the President, with the concurrence of the Chairman of the Board and the Chair of the Committee on Finance, would employ interest rate swaps to reduce the interest expense otherwise achievable in the market on certain bond issues.

University Debt Restructuring

Beginning with the introduction of General Revenue Bonds (GRB) in 2003, UC debt has been restructured to position the University to take advantage of its varied and strong revenue sources. The GRB Indenture was modernized to provide the flexibility to use the full array of financing instruments to achieve the lowest cost of capital for UC projects. A pool of legally available revenues (General Revenues) for debt service was defined to include student fees and non-resident tuition, indirect cost recovery from contracts and grants, sales and service revenue from auxiliaries, and investment income from the Short Term Investment Pool, among other revenues. New projects for research, instruction and infrastructure are financed under the GRB Indenture. When UC debt was restructured, medical center revenues were not included in the pledge of General Revenues.

As the second phase of debt restructuring, the Limited Project Revenue Bond (LPRB) Indenture was introduced in 2004 to expand debt capacity for auxiliary projects (primarily housing and parking), pledging the pooled gross revenues of projects being financed for debt repayment on a subordinate basis to the lien on those revenues under the GRB Indenture. The LPRB Indenture provides the same financing flexibility for auxiliary projects enjoyed by projects for research and instruction under the GRB Indenture.

The third phase of debt restructuring will follow the pooling concept of the GRB and LPRB restructurings by pooling the revenues of all five medical centers for financing any medical center's capital program, regardless of which medical center uses the proceeds of financing. The AMC Indenture will be modernized to provide the same financing flexibility for the medical centers currently enjoyed by core campus and auxiliary projects.

Current Financing for Medical Centers

A medical center's capital needs are currently financed pledging the individual revenues of the medical center whose projects are being financed. This "tub on its own bottom" approach relies on the individual medical center's debt capacity, operations, and penetration of the local market for the bond rating. Current ratings for the medical centers are in the single-A category, with bond pricing reflecting the rating of the medical center being financed.

Current Outstanding Debt for Medical Centers

Current outstanding medical center bonds total \$748 million for four of the five medical centers, approximately 12 percent of all UC debt. The security lien for each bond series pledges only the revenues of the medical center using the bond proceeds.

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<u>Medical Center</u>	<u>Bond Series</u>	<u>Outstanding (\$000)</u>
Davis	2003 Series A-E	\$ 339,600
Los Angeles	2004 Series A –B	\$ 256,165
San Diego	2000 Series A	\$ 57,335
San Francisco *	1998 Series A	\$ 94,895

* San Francisco's bonds were issued by the California Hospital Facilities Financing Authority when the UCSF Medical Center was part of UCSF Stanford Health Care, and were assumed by UC in 2000.

Pooling of Medical Center Revenues

Similar to the pooling of revenues for GRBs and LPRBs, financing for the medical centers will pledge the pooled revenues of the five medical centers for any financing, regardless of which medical center uses the financing proceeds. Pooling the medical center revenues for repayment should result in a higher bond rating than can be achieved by any one of our medical centers alone, even by our two highest rated medical centers, UCSF and San Diego, each rated at the A+/A1 level by Standard & Poor's and Moody's Investors Service. Higher bond ratings translate into reduced borrowing rates and issuance costs, broader access to the financing market, and an increase in debt capacity which is necessary to the creation of debt targets for our medical centers without reducing debt capacity for general campus and auxiliary projects.

Market Characteristics of the Pooled UC Academic Medical Centers

Pooled financing for the medical centers offers quality and size, which improves the attractiveness of the financing to the investor:

- Total revenues: \$4 billion
- Total licensed beds: 3,400
- Geographic diversification of seismic risk
- Market diversification in five of the largest California metropolitan areas (Los Angeles, Orange County, Sacramento, San Diego, and San Francisco).
- Five academic medical centers offering the highest level and complexity of services, including complete tertiary and quaternary service lines.
- Four Level 1 Trauma Centers, with UCSF staffing San Francisco's Level 1 Trauma Center.
- Fifth largest health system nationwide by revenues (Fortune 2005).

Financing for any medical center will benefit from the synergy inherent in the pooling of all medical center revenues.

Internal Management

The pooling of medical center revenues for financing under the AMC Indenture requires no change in the governance structure for the medical centers. Internal structures and processes for medical center management will remain unchanged:

- Each medical center is expected to maximize its business decisions to compete in its local market.
- No medical center will be asked to pay for the costs or debt service of another medical center.
- Each medical center will continue to have access to the Hospital Working Capital program authorized by The Regents from STIP.
- A medical center's borrowing will not exceed the internal assessment of its debt capacity and its allocated debt target.
- Each campus will remain ultimately responsible for the support of its medical center, including payment of debt service, and the approval of the capital program.
- All medical center projects must continue to be approved following the Regental approval thresholds prior to financing.

Integral to the internal management procedures is the prohibition against allocating to a medical center any debt capacity created by the pooling of all medical center revenues in excess of the debt capacity of the medical center itself from its own balance sheet, income statement and market. A memorandum of Internal Principles guiding medical center management has been discussed and approved by the Deans of the Schools of Medicine, the medical CEOs and CFOs, their campus senior management, and the Office of the President (See Attachment I.)

Interest Rate Swaps

Interest rate swaps are contracts to exchange the payment of interest based on a notional amount, generally tied to a bond issuance, in which the University would pay a fixed interest rate which is typically 30 to 100 basis points lower than could otherwise be achieved through the issuance of conventional fixed rate bonds of the same maturity. In exchange, the University would receive in the interest rate swap a percentage of a taxable index, for example, 67 percent of the 30-day London Interbank Offered Rate (LIBOR), or a percentage of a tax-exempt index; for example, 67 percent of Bond Market Association index. The higher interest rate savings are realized when the University accepts the tax risk which the investor typically accepts when buying tax-exempt bonds.

The University employed an interest rate swap for the UC Davis Medical Center refinancing in which the UC Davis Medical Center pays a fixed interest rate of 3.14 percent and receives a variable payment based on 67 percent of LIBOR. The fixed interest rate available at the time of the interest rate swap was approximately 4.5 percent, a rate which would have produced only marginal savings for the medical center.

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Analyses evaluated the savings over time using the 67 percent LIBOR swap across a wide range of LIBOR rates which approximated different levels of tax rates. Interest rate swaps would be employed only when significant savings could be achieved over the issuance of fixed rate bonds. Swaps would be employed only upon the further approvals of the Chairman of the Board and the Chair of the Committee on Finance. Analyses would be provided which would demonstrate the risks and rewards of the particular type of swap being recommended.

Financial Reporting

Each medical center will continue to receive a full scope financial statement audit at the end of each fiscal year. To the extent possible under Generally Accepted Accounting Principles, each medical center will record as a direct liability only the debt used at that medical center. The contingent liability for the medical center associated with the pooling of its revenues under the AMC Indenture will be disclosed in the footnotes to each medical center's financial statements.

Implementation

The AMC Indenture will modernize covenants to provide financing and operational flexibility for the medical centers. UC will engage the investors and insurers for the outstanding bonds to amend the current indentures for those hospital financings to be consistent with the provisions and covenants of the AMC Indenture. The anticipated implementation date to amend all hospital indentures and introduce the AMC Indenture is November 1, 2006.

Summary

Revenues of all UC medical centers will be pooled for financing purposes only. Pooling revenues creates an opportunity to take advantage of the synergy in combining the medical centers activities for financing. Pooling should reduce the costs of financing, resulting in lower interest rates and broader market access. Internal procedures governing the medical centers will be unchanged. Although pooling will increase debt capacity for the medical centers as a system, no medical center will borrow in excess of its individual debt capacity or pay for the costs, including debt service, of another medical center. Covenants for the AMC Indenture will be modernized to provide financing and operational flexibility currently enjoyed by general campus and auxiliary financing. Implementation will include discussions with bondholders and insurers of existing bonds, with a goal of introducing the AMC Indenture and conforming existing indentures to the provisions and covenants of the AMC Indenture by November 1, 2006.

(Attachment)

**PRINCIPLES FOR ESTABLISHING THE UNIVERSITY OF CALIFORNIA
MEDICAL CENTER POOLED FINANCING CREDIT**

The University of California medical centers have been asked to form a Pooled Financing Credit solely to finance the construction, acquisition, and equipping of various capital needs of each medical center. The Pooled Financing Credit permits each medical center financing to be accomplished at higher bond ratings than available to any of the medical centers individually, which translates into lower bond insurance premiums and interest rates and assures access to financial markets.

The medical centers agree to form the UC Medical Center Pooled Financing Credit pursuant to the following principles:

1. Governance

- a. No changes will be made to the governance of any campus's Health Science structure or program to accommodate, or as a result of creating, the Pooled Medical Center Financing Credit.

2. Financial Responsibility

- a. The current University process for satisfying financial obligations and providing financial backstops remains unchanged.
- b. The Chancellor of the campus of each medical center will continue to be ultimately responsible for the operations of that campus' medical center, including the revenues, expenses, capital costs, and debt service.
- c. A medical center is only responsible for its own expenses, debt service costs, and health system transfers for its own Health System, not those of any of the other UC medical centers.
- d. A medical center will continue to be responsible for managing its operations in its local market.
- e. Medical center decisions will not be determined or mandated by the requirement to optimize or strengthen the UC Medical Center Pooled Financing Credit without regard for that medical center's direct benefit.

3. Debt Capacity

- a. In determining a medical center's theoretical debt capacity, the balance sheet, income statement, revenue projections, market position, capital needs, and assumed underlying bond rating of the medical center will be considered. An evaluation of debt capacity does not imply approval for borrowing purposes, but is considered in the Capital Approval and Debt Target processes discussed in #4 below.

- b. A medical center's debt capacity will be validated by joint discussions involving the medical center, its campus, UCOP, and investment banking health care advisors.
- c. No medical center can borrow or use the debt capacity of another medical center
- d. Increases in debt capacity created by virtue of the pooled financing structure will not be allocated to any medical center.

4. Capital Approval Process and Debt Targets

- a. Each medical center's capital program must be approved by its campus.
- b. To the extent that debt targets are assigned to campuses for general campus instruction, research and auxiliary needs, medical centers will also be assigned a medical center debt target as a separate "layer" in the campus total target.
- c. The debt target for a medical center can only be used for medical center projects. It cannot be used by the general campus even if the medical center does not use it during the period applicable to that debt target allocation.
- d. Projects will continue to be approved and amended under the approval process in place for campus projects.

5. Financial Reporting

- a. To the extent possible under GAAP, a medical center will record as a direct liability only the debt which was used to acquire, construct, equip, or lease facilities for that medical center. The contingent liability related to the UC Medical Center Pooled Financing System will be recorded in the footnotes to the financial statements.

6. Modification of Principles

- a. Changes to these principles must be discussed with each campus and medical center.