

**The 'Big 3' – Man-made Disasters that Changed Public Finance History
ORANGE COUNTY, CA
A Modest Chronology**

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| November 1970 | Robert Citron first elected Orange County Treasurer |
| June 1978 | "Peoples' Initiative to Limit Property Taxation" enacted by California voters |
| Mid-1994 | Orange County FY95 budget 35% of general fund revenues to come from investment earnings (vs. 12% prior year) |
| Fall 1994 | Short-term interest rates reach 5.7% (vs. 3% at start of year) |
| November 1994 | Orange County auditors reveal \$1.64 billion in investment losses |
| December 1994 | Orange County and Orange County Investment Pool file petitions for relief under Chapter 9 |
| April 1995 | Settlement reached for 77% payout to OCIP investors; Citron pleads guilty to felony counts |
| June 1995 | Orange County voters reject one-quarter cent recovery sales tax |
| July 1995 | Bankruptcy Court approves one-year rollover of short-term paper |
| August 1995 | Orange County proposes plan of arrangement – pool investors to defer payment indefinitely, \$880 million in proceeds of long-term zero-coupon bonds to be issued to repay short term debt and vendor claims and fund litigation expenses |
| December 1995 | Bankruptcy Court approves plan of arrangement |
| June 1996 | Orange County issues bonds, consummates plan, assumes debt and other obligations on original terms |
| June 1998 | Merrill Lynch settlement announced, \$400mm of \$800mm total |

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WASHINGTON PUBLIC POWER SUPPLY SYSTEM

Background Information

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Between 1968 and 1976, a small Joint Operating Agency in Washington State undertook to build and operate five large nuclear power reactors, as part of a regional “Hydro-Thermal Power Program” that predicted the Pacific Northwest would need twenty additional major thermal generating plants by 1990. The Washington Public Power Supply System, with its unfortunate acronym and more unfortunate financial results, are well-known to those in the municipal securities field. Less evident however, are the specifics of how the Supply System ended up with only one completed nuclear project, staggering cost overruns and, in 1983, the largest municipal bond default in the nation’s history at \$2.25 billion.

As a first approximation to an explanation, one is tempted to invoke Murphy’s Law. Practically everything that could have gone wrong did. A decade of stagflation, exaggerated demand projections, soaring interest rates, a challenging regulatory environment, labor difficulties, antinuclear protests, managerial shortcomings and, at the end, a devastating judicial decision all marked the story of the Supply System’s calamity.

To unravel the tangled web, however, I would emphasize three crucial factors. First, the Washington Public Power Supply System was not organizationally capable of building the projects in a timely and cost effective fashion. An amateur board of directors, a small and provincial managerial staff, contentious labor relations, and complicated and burdensome regulations were among the reasons why the Supply System couldn’t come close to meeting its initial goals. Yet when asked to account for its mounting problems, WPPSS officials tried to pin the blame on tightened NRC regulations, especially following Three Mile Island. A state legislative investigation in 1980, however, sharply rebutted that approach and more realistic estimates suggested that the regulatory contribution to cost overruns was probably no more than about twenty percent.

Second, faulty demand projections motivated the pressure for the Supply System’s projects. Electricity had transformed the Pacific Northwest in the mid-twentieth century with massive hydropower development on the Columbia River and its tributaries. By the 1960s, Bonneville Power Administration was marketing hydro to public utilities for less than a penny a kilowatt-hour. Not surprisingly, demand soared about seven percent annually. The demand forecasts in the Hydro-Thermal Power Program extrapolated that rapid growth into a very different energy environment. Policymakers were generally oblivious to the notion that higher prices would slow demand growth. In 1972, responding to a question about the impact of price on demand, a BPA

manager replied “Well, off-hand I can say we haven’t considered that.” By the end of that decade, Northwest power planners were desperately seeking buyers for what promised to be huge surpluses of electricity that the plants would provide.

Finally, the proximate cause of the default was the controversial Washington State Supreme Court decision *Chemical Bank v. WPPSS* (666 P.2d 329), issued June 15, 1983. The year before, in the face of new estimates that it would cost as much as \$23.9 billion to complete all five plants, and with a growing awareness of the leveling of demand, the Supply System had reluctantly terminated Projects Four and Five. A complex arrangement called Net Billing had financed the first three projects, making Bonneville an implicit guarantor of the bonds. Net billing was not available for Projects Four and Five. Bonneville and the Supply System had cajoled and scared eighty-eight regional public utilities into signing Participants’ Agreements for shares of “project capability.” When the plants were terminated, the unappealing prospect for the participants was to pay off \$2.25 billion in bonds without getting a kilowatt-hour of energy in return. Several of them refused, and the Supply System itself could not pay the Project Four and Five bondholders. As bond trustee, Chemical Bank sued for a declaratory judgment against WPPSS and the bondholders. In *Chemical Bank v. WPPSS*, the state Supreme Court ruled 5-2 that the Participants’ purchases of shares of “project capability” had been *ultra vires* and thus that the utilities were not obliged to pay off the bonds. Furious bondholders responded with a wave of lawsuits claiming misrepresentation in the sales of the bonds for the terminated projects. These were consolidated into Multidistrict Litigation 551.

MDL 551 was a case of such extraordinary complexity and magnitude that it is hard to see how an adversarial trial by jury could have resolved it. “God, we’ve got to settle...” noted BPA Administrator Peter Johnson in 1986, a sentiment echoed by more and more parties to the suit. Settlements began as Judge William Browning prepared to begin the trial in Tucson in 1988. A few weeks of trial activity provoked further settlements. In the end, settlements amounted to nearly \$700 million, larger than any previous securities class action recovery. The payoffs were large enough to inflict pain on some of the defendants (though others were covered by insurance) but not enough to satisfy many bondholders. Northwestern public utility customers now find themselves paying rates not much lower than the national average. Part of their monthly bill goes to pay off bonds issued to build the Net Billed projects. Two of those three were terminated in 1994. It is hard to find a clear-cut villain in the WPPSS fiasco, and it is equally difficult to discover any of the conflicting parties who could claim to be a victor.

As an historian with no special training or background in either law or finance, I am most interested in hearing from my fellow panelists, our moderator and members of the audience about how the WPPSS case looks to the municipal finance community. I look forward to your comments

The ‘Big 3’ – Man-made Disasters that Changed Public Finance History NEW YORK CITY 1975-1981: The Granddaddy of Muni Distressed Credit

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It was 37 years ago this month that New York City’s fiscal crisis made history; there are many in the audience that weren’t even born yet when the Big Apple lost access to the municipal credit market and rattled financial markets world-wide. So I guess that leaves it up to this wizened gray-haired analyst to recount a period of tumult that eventually resulted in important lessons for the art of municipal analysis.

A warning shot across the bow came in March 1975, in the form of a default on bond anticipation notes by the Urban Development Corporation (UDC). Although the UDC was not a part of city government, and had no pledge of city resources, the projects it financed were in the city’s limits. Rumors were circulating that New York was in a cash crisis that could only be solved by cash flow borrowing. The problem was that the city had already borrowed about \$4 billion, revenues were falling short at the tail-end of the ’72-74 recession, and questions were being raised about the city’s ability to repay notes without having to borrow additional seasonal cash. On April 4, 1975, S&P suspended the city’s single ‘A’ rating, citing inadequate information to make even an educated guess about its true financial position and cash flow for the coming months.

Like a recession, this crisis has a starting point, and an end date. Some say that S&P’s rating suspension was the official start of the crisis; most would observe that the end came in the spring of 1981, when New York obtained its first investment grade rating in nearly six years and was finally able to borrow money in the public market without the “visible means of support” from federal guarantees or the financing vehicle Municipal Assistance Corporation, commonly referred to as MAC.

It took a year or more to ascertain what the city’s true financial position was, after the city acknowledged that it could not repay debt maturities without using future borrowed funds. Accounting gimmickry had allowed the city to run 15 consecutive years of deficits before the financial house of cards crashed in 1975. At one point, the city had \$6 billion of short-term debt coming due within a year or less; this on an annual budget of about \$15 billion. In 2012, that would be the equivalent of California issuing RANS of more than \$50 billion. There were fears that a NYC bankruptcy could roil international financial markets; indeed, some of the city’s major banks had 20% of their capital tied up in city notes and bonds. In 1975, the Big Apple was truly America’s version of Greece.

Rather than dwell upon how and why New York reached this crucial condition, let’s focus instead on what came out of the largest threat to the safe operation of the U.S. tax-exempt market. There were many lessons learned, and legacies which still act to keep “muniland” operating as a model for state and local government borrowing that is the envy of the financial world.

All of the analysts in the NFMA can thank New York’s financial crisis for their career. The sins of New York provided the fodder that re-shaped municipal credit analysis in the modern era. New York in 1975 was the definition of Murphy’s Law: Whatever could go wrong, did go wrong, and at the worst possible time. The forensic financial analysis required to determine how New York could arrive at the brink of bankruptcy taught us new lessons that we still use today, in a wide array of areas:

- Cash flow borrowing analysis
- Financial accounting and reporting
- Debt management
- Budgetary management
- Long-term economic and tax base analysis
- Intergovernmental relations between cities, states and the federal government.
- Pension obligation analysis

New York's legendary accounting chicanery directly led to the push for standardized accounting and the application of Generally Accepted Accounting Principles in the late 1970's and early 1980's. That impetus has resulted in near-universal application of standardized financial reporting and auditing of state and local books.

The creation of New York's Municipal Assistance Corporation (MAC) and Emergency Financial Control Board provided a model to help rescue financially distressed cities that was later emulated in Philadelphia, Washington D.C., the Chicago Board of Education, and will be a resource as Detroit and the State of Michigan try to move that distressed city into long-term financial stability.

Bond insurance in 1975 was a novelty, with AMBAC starting in 1971, followed by MBIA in 1974. Few, if any, NYC bonds were insured before the crisis. Default on a muni, rare then as it is now, was highlighted. The New York financial crisis didn't automatically jump start the bond insurance industry; the real growth came after Washington Public Power (another of today's case studies) defaulted, and AMBAC paid in full on defaulted debt in 1982. The New York financial crisis provided fertilizer for this budding industry; the WPPSS default led to the "bumper crop" of insured bond issues which eventually resulted in 50% of annual new issue volume being backed by bond insurance.

The New York financial crisis pointed out the glaring lack of independent credit analysis in the tax-exempt sector. I am a creature of the crisis. After being criticized for upgrading New York to single 'A' just prior to NY's near bankruptcy, the rating agencies realized that they had to severely beef up their staffs to prevent a replay of missing the boat. I was in the first wave of new hires at S&P in July 1975 when I started my career. I was the fourteenth member of a department that had been comprised of only two secretaries, two clerical assistants and nine municipal analysts...one of those analysts was the legendary Hy Grossman, who I still to this day consider to be my mentor. By 1985, ten years after the crisis, S&P's municipal department had grown to 135 analysts and support staff. Moody's followed a similar growth pattern.

The crisis also resulted in the first real push for improved financial disclosure. Official statements more than tripled in size, as it became standard operating procedure to include pension fund data and the last audited financial report as an appendix. It was a slow and torturous path before we could get to the operation of debt repositories, and today's EMMA system of secondary market disclosure. New York's crisis started that ball rolling.

Finally, the crisis was the catalyst for the opening of the "black box" of bond ratings. In 1979, realizing that there were still credibility problems because of its handling of its rating on the Big Apple, S&P made the strategic decision to memorialize and write down its rating procedures and the criteria by which it arrived at ratings. Starting first in the municipal and corporate areas, S&P expanded the process to cover its entire universe of ratings, including Insurance, International, Banking and Structured Finance. The most important decision was to take those written standards and criteria and disseminate them widely, for free, to any interested parties. S&P's motivation was simple. At the time, Ford Motors was famous for its slogan, "The More You Look, The Better We Look". S&P believed that by opening its process and standards to the financial community, it would help burnish its reputation and solidify its franchise for debt ratings. In retrospect, it's clear that that strategy was successful, as people now complain that the rating agency franchise perhaps became too powerful and influential in the last decade, contributing to our current and ongoing financial crisis. This legacy of "opening the black box" is still very much in operation, as recent legislation that regulates the rating agencies requires, as standard operating procedure, the public dissemination of rating criteria and standards, and any revisions that may be contemplated in those standards.

New York's financial crisis was a deep, dark cloud that some might argue is the worst financial melt-down in the tax-exempt municipal bond market. But the lessons learned, and the legacies that were spawned, are clearly a bright "silver lining" that continues to influence all of the more than 1,000 members of the National Federation of Municipal Analysts.