<u>Special Report</u>

Bond Basics/Blue Lake Bond Proceeds Update

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Bond Basics

In its basic form, a bond is evidence of a loan, i.e., a financial contract in which one entity (the borrower) receives funds from another entity (the bondholder) in return for a contractual pledge to repay the funds **(called principal)** at a specific time in the future, and, to pay interest on principal at specific times until the principal is repaid.

Key bonding terms and concepts are as follows:

- Bonds are typically issued in a structure in which certain principal amounts of bonds are repaid annually. This is called a **serial structure** and is set forth in a **bond resolution or indenture**. The date upon which the principal of a specific bond is repaid is the called **maturity date of the bond**.
- The funds received from the bondholder are called **bond proceeds**.

As a bond is a financial contract to repay principal at a specific time in the future, the principal and associated interest of a bond can only be repaid according to the bond resolution or indenture with limited exceptions. The limited exceptions are (1) if the bonds are callable by the issuers (have a **call feature**); or (2) are **defeased**.

A **call feature** means that the borrower has the option to pay off bonds early (on a **call date**). Unlike most home mortgages, bonds typically cannot be refinanced – or are "non-callable"--for ten years after they are issued. The bond resolution or indenture spells out the specific dates and circumstances in which the borrower can call bonds. When bonds are called, the borrower repays the principal amount of the bond and any interest owing as of the call date.

A **defeasance** means that the borrower places funds in trust in an amount that would pay all future interest and principal payments on bonds until the maturity date or call date (if that's earlier than the maturity date). A defeasance, therefore, makes sense when (1) the borrower can refinance higher interest debt by issuing lower interest debt and using the new bond issuance proceeds to defease the original debt

Sitka's Electric Revenue Bonds

Sitka issued $126,170,000 principal amount of electric revenue bonds in four separate bond issuances from 2010 thru 2014. The bond proceeds were used for three purposes (1) to retire and defease outstanding Green Lake Bonds (in 2010); (2) to raise funding for the construction of the Blue Lake Hydroelectric Project; and, (3) to raise matching funds for the Jarvis Street Solar Diesel Turbine Project.

As of November 9, 2016, $115,520,000 principal amount of electric revenue bonds remain outstanding.

Sitka issued all of these bonds to the Alaska Municipal Bond Bank Authority (AMBBA), in return for loans from the Authority. Sitka did not directly issue bonds to the public. The reason for doing so is that Sitka would have had to pay much higher interest on the bonds it issued had it done so.

When bonds are issued through the AMBBA, the AMBBA issues its own bonds to the public. AMBBA uses the proceeds of its bonds to make loans to municipal borrowers, like Sitka. The municipal borrowers in turn issue their bonds to AMBBA as the security and source of payment for debt service on

AMBBA's own bonds. Each municipal borrower also enters into a loan agreement with AMBBA that sets forth certain requirements relating to repayment of the borrower's bond.

The AMBBA has a bond resolution covering its public offering; the terms of that resolution are binding on the borrowing Municipalities. In AMBBA bond issuances in which Sitka was a borrower,, multiple other Alaskan municipalities also participated. Thus, the AMBBA structures its public bond issuance built on the underlying debt structures of the participating municipal borrowers.

As Sitka issued its bonds to the AMBBA in return for loans, Sitka is bound by terms of its loan agreements with the AMBBA. The terms of each loan agreement specify that Sitka will make payments of interest and principal equal to the amounts the AMBBA is required to make so as to provide funds sufficient to pay the amounts due on the AMBBA's bonds. Thus, the bonds which Sitka issued to the AMBBA have installment dates indicated on them in which installment payments are due to the AMBBA.

AMBBA bonds all have a 10-year non-call feature. This means that AMBBA can't call its bonds until at least 10 calendar years have expired. The bonds are continuously callable thereafter. This restriction is, in effect, passed on to Sitka in the bonds that it issues to AMBBA and in the loan agreements it enters into with AMBBA. Sitka has participated in several refundings of older general obligation bonds in conjunction with calls and defeasance. But Sitka cannot, on its own, pay off its bond obligations to the AMBBA early.

The loan agreements obligate Sitka to make bond interest and principal payments as scheduled by the AMBBA. Sitka may redeem bonds early, but if it does, it must pay all interest due up to the normal maturity date or call date (if earlier). **Per the loan agreement. Sitka can't redeem a portion of its bonds to the AMBBA early and be excused from paying further interest on the scheduled maturities**.

The Assembly's Specific Question

Can the remaining bond proceeds from the final 2014 electric revenue bond issuance be returned so Sitka does not have to pay interest on the unused proceeds?

Following on the discussion above, the answer is no. Sitka can use unspent proceeds of the 2014 bond to repay its loan obligation to the AMBBA only in accordance with the early payment rules imposed by the AMBBA. In other words, Sitka could redeem a portion of its bond to the AMBBA early, as described above, but it still must pay all interest on the amount being redeemed up to the maturity date or call date (if earlier).