Chapter 4

Financing Guidelines

4.1 METHODS OF FINANCE

Available financing options

Capital projects may be financed by a variety of methods ranging from cash to forms of long-term debt. Agencies must propose a method of financing for each project.

The most common financing alternatives and their distinguishing characteristics are described below. Chapters 4.2 to 4.4 outline allowable uses and limitations of the various available financing options. Questions about the selection of financing options by the requesting agency or about a specific financing proposal should be referred to your assigned OFM capital budget analyst.

Long-term financing

- **General obligation bonds** are the traditional form of government debt financing for major construction projects. The state pledges full faith and credit and taxing power to pay principal and interest. The term of the bond is usually 25 years. The interest paid to investors is exempt from federal income tax and the rates are typically below taxable bonds. General obligation bonds are subject to a state debt limit. Legislation authorizing general obligation bonds requires a 60 percent vote by the Legislature.
- **Reimbursable bonds** are a form of general obligation bonds. The difference is the source of payment. Reimbursable bonds are paid from sources other than the general fund.

Other financing

- **Cash** may be used from a dedicated account to finance capital projects if sufficient capacity is in the account. Agencies must show that this account has sufficient capacity. Agencies should ensure the proposed project is meeting the restrictions of the funding source.
- **Financing contracts** can take several forms, including certificates of participation and certain lease-purchase and lease-development agreements. All financing contracts must be approved by the State Finance Committee.
- **Certificates of participation** (COP) are a form of debt financing contract with individual investors. COPs are sold in the public securities market and the interest earnings are tax-exempt. Debt service payments are made from operating budgets or other revenue sources such as student fees.
- **Lease purchase and lease development agreements** are forms of financing contracts that enable a building to be built or substantially remodeled to state specifications by a private developer. In both cases, the developer finances the project and recovers the cost through lease payments. By the end of the lease period, the state may exercise the option to purchase at a predetermined price. There is no tax exemption for the developer, and market interest rates prevail.

Long-term leases

Long-term leases are not considered to be a debt of the state and lease payments are made from agency operating budgets. The standard lease term employed by the state is five years. However, if an agency is expected to have a consistent and stable presence in the location, there is a demonstrated economic advantage to the state, **and** the location meets facilities standards established by the Department of Enterprise Services (DES), a lease of up to 10 years may be negotiated by DES after consultation with

OFM. A long-term lease of more than 10 years can be negotiated by DES and must be approved by OFM. Any lease over 20 years in duration must have legislative authorization.

A lease also must have the approval of OFM if it is for space under development or has an obligation of over $1 million annually, regardless of the length of the lease obligation.

4.2 ALLOWABLE USES OF LONG-TERM FINANCING

Long-term financing uses are limited. By law, only certain types of expenditures can be funded with long-term financing options. The following table outlines the allowable and non-allowable uses of long-term financing:

Allowable Uses	Non-Allowable Uses and Caveats
1. Acquisition – land and buildings	
Expenditures for the acquisition of real property, whether obtained by purchase or by condemnation under the applicable eminent domain laws of the state of Washington, including expenses directly and necessarily related to such purchase or condemnation. The cost of existing structures that improve the real property, such as buildings, facilities, roads, parking areas and bridges. Costs may include: ▪ land and improvement costs ▪ appraisal fees ▪ title opinions ▪ surveying fees ▪ real estate fees ▪ title transfer taxes ▪ easements of record with an extended term ▪ condemnation costs ▪ related legal expenses	Land purchases must be consistent with agency master plans and reflect actions taken to meet long-term growth needs. Financed land purchases for the purpose of investment or land banking are not allowable.
2. Planning and consultant services for predesign and design work	
Costs may include: ▪ preliminary technical studies developed from program statements that reflect the functional characteristics and architectural requirements of a long-term financed capital improvement project (predesign) ▪ costs for architectural and engineering services, such as schematic design, design development and construction documents ▪ reimbursable expenses provided in an executed contract for professional and technical services ▪ fees for construction management and observation	Expenditures for general long-range development plans, master plans, historical or archeological research, feasibility studies, statements, energy audits, or other expenditures similar in character are *not* financed from bonds or other long-term financing. These costs should be contained in the agency's operating budget. LEED certification fees not associated with construction.

Allowable Uses	Non-Allowable Uses and Caveats
▪ LEED certification fees as part of a construction project	
3. Construction – site improvement costs	
Site improvement expenditures include costs related to a financed capital improvement project, including: ▪ demolition ▪ rough and final grading of a site ▪ construction or replacement of sidewalks ▪ road and driveway pavement surfaces ▪ bridges ▪ ramps ▪ curbs ▪ overpasses ▪ underpasses ▪ pedestrian bridges and tunnels ▪ surface parking areas ▪ campground development ▪ building terraces ▪ retaining walls ▪ exterior lighting ▪ seeding or sodding for erosion control Landscaping costs are financed only if the costs are included as part of a larger financed capital project. Site improvement projects not part of a larger capital project may be financed if the structure or improvement provided is permanent and meets all other tests and requirements of these guidelines. Demolition of buildings and structures, removal of trees and plant material, grading, rerouting of utilities, and erosion control may be financed when they precede a financed project to be undertaken on the same site. Clearing of land or demolition of vacant buildings is usually financed only in preparation for a financed construction project.	Routine maintenance of land.

<table>
<tr><th>Allowable Uses</th><th>Non-Allowable Uses and Caveats</th></tr>
<tr><td colspan="2">4. Construction – road work</td></tr>
<tr><td>Costs related to the construction, extension, replacement, reconstruction or upgrading of a new road or parking lot. The following are considered part of roadwork costs:
▪ all necessary signing
▪ landscaping
▪ erosion control
▪ drainage
▪ lighting
▪ bridges
▪ safety
▪ control structures</td><td>Repairs or resurfacing of existing roads to temporarily extend useful life are not allowed.</td></tr>
<tr><td colspan="2">5. Construction – facilities preservation</td></tr>
<tr><td>Expenditures for the reconstruction or preservation improvement of existing buildings or structures are allowed, including:
▪ Site developments necessarily required or related to the preparation of a site for reconstruction purposes (see Site Improvement Costs).
▪ Required built-in, special purpose or other fixed equipment where such equipment is permanently affixed or connected to real property in such a manner that removal would cause damage to the real property to which it is affixed.
▪ Expenditures for the installation or replacement of water control structures such as dams, culverts, aqueducts, drainage systems, locks, spillways, reservoirs and channel improvements.</td><td>Normally recurring expenses associated with water control structure improvements are not financed, unless part of a larger financed project.</td></tr>
</table>

<table>
<tr><th>Allowable Uses</th><th>Non-Allowable Uses and Caveats</th></tr>
<tr><td colspan="2">6. Construction – utilities</td></tr>
<tr><td>Expenditures for the acquisition, construction, replacement, modification or extension of utility systems, including construction or replacement of utility lines between buildings, replacement or installation of utilities to off-site supply systems, and replacement of complete boiler or central air conditioning or ventilation systems. These include:
▪ Provisions for potable water, high temperature water for sanitary or other related purposes, and domestic hot or chilled water.
▪ Systems and associated components for disbursing or providing electricity or telecommunications service, including underground or overhead distribution cables for television, computers or other modes of communication.
▪ Steam and condensate returns.
▪ Storm and sanitary sewers.
▪ Fire hydrants and stand pipes.
▪ Central fire and security alert systems.
▪ Lighting systems.
▪ Tap-ons or extensions related to existing utility systems.
▪ Automated temperature or environmental control systems, and air or water pollution control systems.
▪ Provisions for the disposal of contaminated, radioactive, hazardous or surgical waste as part of a construction project.
▪ Solar heating or other approved energy systems as part of a financed construction or reconstruction project.
▪ Sewage and water treatment facilities, equipment and related systems.
▪ Earth moving to create artificial lakes or reservoirs for utility or related purposes.
▪ Restoration of natural and manmade features of the site.
▪ Trenches or ditches dug for the purpose of laying tile or providing other means to remove excessive rainfall and prevent erosion.</td><td>Non-financed utility repairs may include minor replacement of corroded or leaking pipes inside a facility, replacement of unsafe or undersized wiring, repairs to stop leaks, replacement of heating or cooling coils, replacement of radiators, fans or motors, retubing of boilers, addition of controls or valves for energy conservation, or replacement of thermostats or timers.</td></tr>
<tr><td colspan="2">7. Construction – safety and codes</td></tr>
<tr><td>Use the same criteria as in #6 above to determine whether the proposed safety or code project is long-term financed.</td><td>Examples of non-financed work, unless included in a larger financed remodeling or reconstruction project, include installation of fire alarms, smoke detectors or automatic door closers.</td></tr>
</table>

Allowable Uses	Non-Allowable Uses and Caveats
8. Equipment	
Built-in equipment is permanently attached to the building or improvement, without which the building or improvement will not function. It is an integral part of the structure, and for purposes of classification, is considered part of the structure. Built-in equipment is generally included in the base construction budget and estimate (Section C of Project Cost Estimate). Examples of built-in equipment are plumbing fixtures and heating and electrical equipment. **Fixed equipment** is attached to the building or improvement for purposes of securing the item and contributes to the facility's function. Fixed equipment is generally included in the base construction budget and estimate (Section C of Project Cost Estimate). Examples of fixed equipment include shelving, cabinets and bolted furniture. **Some movable equipment** can be considered long-term if it is part of a large construction project. Movable equipment is necessary for the functioning of the building or improvement and remains with the facility in support of a program, but is not attached to the building or improvement. Movable equipment is generally included in a separate equipment budget and estimate (Section D of Project Cost Estimate). Examples of movable equipment include desks and computers. Check with your OFM capital analyst if you have questions.	**Consumable inventories**, as defined in SAAM, are supplies consumed in the course of an agency's operation or incidental items held for resale (see Glossary). Consumable inventories are not eligible. Examples include office, janitorial and chemical supplies, and laboratory glassware. **Software** is not an eligible expenditure if it is not dedicated to the control of a specialized system supporting a program. Examples not eligible include word processing and project management software. **Spare or replacement parts for equipment** are not eligible. Equipment traditionally funded from the operating budget (or specifically prohibited equipment such as fax machines, copiers, custodial equipment, rolling stock and grounds equipment) is not eligible. The useful life of the equipment is less than13 years. However, cash funds can be used in the capital project. **Temporary equipment** that is planned to be used in a building or improvement for a period less than its useful life. An example of temporary equipment is the use of research equipment for a short-term project.

Allowable Uses	Non-Allowable Uses and Caveats
9. Other costs	
▪ Fees for services for retaining, complying with, or legal costs associated with environmental or other construction permits required for developing and implementing a specific capital improvement project. ▪ Purchase of existing facilities and tenant improvements. ▪ Reconstruction of an existing building or structure, which may include demolition or installation of new structural or interior walls, floors, ceilings, utilities, interior finishes, furnishings and equipment. ▪ Exterior work (including exterior surface), structural, or foundation work necessary to extend the useful life of the structure. ▪ Roof work that removes all or major portions of a roofing system down to the decking and replacement with a new system. ▪ Replacement of insulation, decking and other necessary structural work that may be part of a financed roof replacement project. ▪ Stone or metal work and other work necessary to direct and control water drainage and ice formation. ▪ Interior work generally involves the following elements of work: demolition, moving of walls, new carpet or floor surfaces, new finishes, replacement of electrical and plumbing facilities, changes to the heating or cooling system, and installation of new fixed or moveable equipment. ▪ Relocation costs that are payments made to owners or occupants of property that the state is acquiring. These costs may be long-term financed when paid pursuant to federal or state statutes. ▪ Allowable agency administrative costs as described in Chapter 5.	▪ Non-financed roof repairs include patching, replacing shingles, spot treatment with tar or other roof materials, adding gravel or other materials, or other repairs. ▪ Replacing gutters, downspouts, fascia and other work are not financed as a project but may be included as part of a larger long-term financed roof replacement project. ▪ Moving furniture, equipment and supplies between facilities are operating costs and not included in capital projects. ▪ Projects that cost less than $25,000 or which have an estimated useful life of less than 13 years. ▪ Ordinary maintenance such as patching, painting, caulking, weatherproofing, insulating, adding storm windows, replacing doors, repairing vandalism or cleaning. An aggregation of ordinary maintenance does not create a long-term financed capital project. Work undertaken as a result of deferred maintenance likewise does not normally make the project long-term financed. Elements of work that are not financed if considered separately may be included in a larger long-term financed project. ▪ Lease payments for rental of equipment or facilities. ▪ Costs for archeological digs, research or exploration, unless part of a construction project. ▪ Expenditures to acquire or construct temporary facilities or for facilities where abandonment or replacement is imminent. This does not include temporary facilities required by a contractor during construction such as a "job shack." ▪ Separate purchases of sand, gravel, rock, asphalt or concrete in limited quantities, ordinary hardware items and temporary fencing. ▪ Spare or replacement parts and equipment, hand tools, scuba equipment, decorative models, plaques, commemorative memorabilia, supplies or other commodities. ▪ Purchase of automobiles, trucks, farm or construction equipment, boats, tractors, lawn mowers, fire engines, trailer-mounted electrical generators, airplanes, helicopters and related items. ▪ Livestock or laboratory animals. ▪ Unpredictable or unusual legal expenses (other than those associated with land acquisition) which are not ordinarily provided in the budget for a capital project. ▪ Parking costs during construction. ▪ Agency expenses for capital budgeting, planning or other costs not directly related to the completion of a long-term financed project.

4.3 ALLOWABLE USES OF BOND AND COP PROCEEDS

Background

These guidelines should be used in preparing capital budget requests for projects funded by bonds and certificates of participation (COP). Agencies *must* review projects to determine whether IRS regulations will require taxable financing rather than tax-exempt financing. The guidelines apply to *all* projects identified in CBS with proposed appropriations and/or reappropriations of more than or equal to $250,000 from the following list of funds or any COP-funded projects:

01L	Higher Education Construction Account
045	State Vehicle Parking Account
051	State and Local Improvement Revolving Account
055	State and Local Improvement Revolving Account (Waste Facilities 1980)
057	State Building Construction Account
070	Outdoor Recreation Account
072	State and Local Improvement Revolving Account (Water Supply Facilities)
09C	Farmland Preservation Account
09G	Riparian Protection Account
10T	Multimodal Transportation Account
18B	Columbia River Basin Taxable Bond Water Supply Development Account
244	Habitat Conservation Account
355	State Taxable Building Construction Account
357	Gardner-Evans Higher Education Construction Account
359	School Construction and Skill Centers Building Account
10P	Columbia River Basin Water Supply Development Account
COP	Certificates of Participation/Alternate Financing Sources
	New capital project funds (if a new bond bill)

Internal Revenue Service limits on tax-exempt bonds

The Internal Revenue Service limits the issuance of tax-exempt bonds that may be used to finance facilities used by nongovernmental entities for nongovernmental purposes. In general, no more than the *lesser* of 10 percent or $15 million of proceeds of any tax-exempt bond issue may be used for any nongovernmental use, of which no more than the *lesser* of 5 percent or $5 million may be used to make any loans to nongovernmental persons. Projects exceeding these limits cannot use tax-exempt bond/COP proceeds, but instead must use taxable (or some combination of taxable and tax-exempt) bond/COP proceeds.

For this purpose, under federal tax rules that apply to tax-exempt state and local bonds, a "nongovernmental person" includes (a) the federal government (including any federal department or agency); (b) any private nonprofit corporation (including any "501(c)(3) organization"); (c) any other private entity, such as a business corporation, partnership, limited liability company, or association, etc.; and (d) any natural person engaged in a trade or business activity.

If the project qualifies for nontaxable funding, request funding from your usual and accustomed funding source. If the project requires taxable funding, request funding from the State Taxable Building Construction Account (Account 355).

Agencies must submit an Expected Use of Proceeds form

Please prepare a separate "Expected Use of Bond/COP Proceeds" form for each proposed project with appropriations and/or reappropriations of $250,000 or more and attach this form to the project in CBS. (The form is available at http://www.ofm.wa.gov/budget/forms.asp.)

Guide to defining governmental vs. nongovernmental use

In preparing the "Expected Use of Bond/COP Proceeds" form, consider the definitions for ***nongovernmental purposes*** and ***governmental purposes*** in the glossary and the examples below.

In determining whether bond/COP proceeds are considered to be used for governmental or nongovernmental purposes, the following federal tax rules should be kept in mind:

- Generally, the ultimate use of the financed property determines the character of the use of the financed property.
- Be sure to consider the reasonably expected direct and indirect uses of both the proceeds and the financed property during the entire term of the bonds/COPs that will finance that property.
- Nongovernmental use may occur as the result of ownership of the financed property by a nongovernmental person. It also may occur through the use of the financed property by a nongovernmental person under a lease, management contract, output contract, or any other arrangement that provides special legal entitlements to the nongovernmental person for beneficial use of the bond-financed property.
- Depending on the particular facts and circumstances, an agreement by a nongovernmental person (such as a business corporation or the federal government) to sponsor research performed by a *governmental* person (such as a state university) may result in nongovernmental use of the property used to perform the research. Under other circumstances, as provided in guidelines issued by the Internal Revenue Service, certain types of research agreements with nongovernmental persons do *not* result in nongovernmental use of the property used to perform the research. It is important, therefore, that the terms of any research agreement(s) are described in the "Expected Use of Bond/COP Proceeds" form mentioned above.

Examples

1. If a state agency leases excess office space in a bond or COP-financed building to commercial businesses, a federal agency, or a private non-profit organization, the portion of the proceeds allocated to the cost of that space is considered used for nongovernmental purposes.
2. If the estimated useful life of a project is shorter than the term of the financing and the project will be sold or leased to a private nonprofit corporation before the end of the financing, the project is considered used for nongovernmental purposes.
3. If proceeds are loaned to a housing authority to build an apartment building that the housing authority leases to a separate partnership in which the housing authority is the general partner and private investors are limited partners, the financed apartment building is considered used for nongovernmental purposes.
4. If proceeds are loaned to a city to build a sewage treatment plant, but the city enters into a long-term management contract with a private company to operate the sewage treatment plant for the city, and the management contract fails to meet Internal Revenue Service requirements for a "qualified management contract," the plant is considered used for a nongovernmental purposes.
5. If proceeds are loaned to a port district to build a dock that the port district leases on a long-term basis to a private shipping company, the dock is considered used for nongovernmental purposes.

4.4 CERTIFICATES OF PARTICIPATION

Consult with Office of the State Treasurer early when considering COP financing

Real estate Certificates of Participation (COPs) are structured and sold on a stand-alone or pooled basis, so agencies with COP approval must coordinate the timing of their funding needs with the Office of the State Treasurer (OST). Due to tax restrictions on the use of COP proceeds and the requirement that the subject property shall secure the financing contract, it is advisable to contact OST directly to describe your project proposal in advance of submitting your budget request.

This is especially important if the proposed project: (a) has any type of private component; (b) includes plans to finance a project on land owned by another party; or (c) involves a private operator or manager of the completed project or portion of the project (such as the operation of food service facilities by a private concessionaire or food service provider).

Tax-exempt COPs are subject to the same restrictions on nongovernmental use of the financed project or asset as those that apply to bonds.

COP limitations

COP authorizations apply only to the biennium for which they are approved. If the project is not ready to finance in the biennium, the agency will need to seek re-authorization in the next biennium.

In accordance with Chapter RCW 39.94 , the maximum allowable term for COPs is 25 years. However, in actual practice the maximum term is 20 years, but they are issued for shorter terms based on the size of the project, the source, amount and timing of agency funds available for repayment, as well as the useful life of the structure.

Regardless of the source of agency funds to be used for repayment, all COPs are secured by the agency's General Fund-State appropriations. If the funds are not sufficient to make payments, general appropriations are required to make the payment.

When are COPs issued?

COPs will be issued for construction projects once the agency has executed a contract for the delivery of its project at a specific price and date. COPs may be used with design-bid-build, general contractor-construction manager, and design-build project delivery methods. For acquisition projects, the agency must have entered into a purchase and sale agreement, completed all requirements for the purchase, and had documents signed by all parties.

Additional information is available on OST's website

Additional information on COPs can be found in the "Lease/Purchase Program Guide" on the Office of the State Treasurer's website at: http://www.tre.wa.gov/government/leasePurchaseProgram.shtml.