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Looking Through the Credit The Oregon School Bond Guarantee Program



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The Oregon School Bond Guarantee Program was established in 1998 for the purpose of reducing the likelihood of interest payment defaults by Oregon educational districts. The program allows the Office of the Treasurer to guarantee the general obligation bonds of school districts, education service districts and community colleges in order to provide interest cost savings to state taxpayers. Since its inception, the program has provided an estimated debt service savings to Oregon taxpayers of roughly \$5 million per year. As of May 31, 2011, there was a total principal amount outstanding in the program of approximately \$3.27 billion covering 253 individual issues. This article reviews the history, mechanics, credit features, taxpayer benefits and what we anticipate for the future of the program.

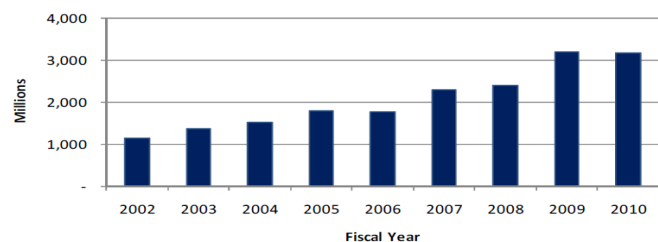
In 2007, there were seven bond insurers rated AAA by the three major rating agencies, today there are no AAA rated bond insurers. In the absence of AAA rated bond insurance, institutional and individual investors alike are questioning the value of credit enhancement. Leading up to 2007, the market saw an explosion of AAA rated middle-market paper as local governments took advantage of inexpensive insurance while four major insurers fought for market share by undercutting each other's pricing and selling their AAA rating, which had become a commodity in the marketplace due to the oversaturation of insured issues.

State school bond guarantee programs are another type of credit enhancement which on the surface may appear like bond insurance, but mechanically are quite different. Despite increasingly restrictive budgets, state governments have continued to provide bond enhancement programs to increase economic activity and assist local jurisdictions in gaining access to the capital markets. The goal of such programs is to enhance the marketability of local issues by providing additional security, often in the form of an explicit state guarantee or state aid intercept. Like bond insurance, rating agencies typically assign an enhanced rating along with an underlying issuer credit rating, if requested.

Background

In Oregon, the Office of the Treasurer administers the Oregon School Bond Guarantee Program (OSBG), which is available to school districts, education service districts and community colleges. Oregon Legislature passed the School Bond Guaranty Act in 1997, which was subsequently approved by voters via a constitutional amendment the following year allowing the State to guarantee voter-approved General Obligation (GO) bonds of qualifying Oregon education districts. Last year, OSBG enhanced 11 issues ranging in size from \$4 million to \$41.5 million and geographically covering the entire State from the coastal City of Warrenton in the west to the borders of Idaho in the east. The amount of debt that the State may incur in honoring its guaranty of school bonds is limited to one-half of one percent of the real market value (RMV) of all taxable property in the State. As of May 31, 2011 there was a total principal amount outstanding of approximately \$3.27 billion issued by 123 school districts.

**Oregon School GO Bonds
Guaranteed by OSBG Program**



Source: State Debt Policy Advisory Commission Report, Dated February 16, 2011



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Program Mechanics

Upon determination of a district's eligibility, the State Treasurer issues a certificate of qualification valid for one year from the date of issuance, which may be applied to all GO bonds issued by a qualifying district during that period. As of May 31, 2011 there were 14 school districts recently qualified to use the OSBG for new issues.

The administrative aspects of OSBG program have been designed to reduce the likelihood of payment default by educational districts. District business administrators are required to transfer funds to their paying agent at least 15 days prior to debt service payments. If the district is unable to do so, the district must notify both the paying agent and the State Treasurer's office at that time. The paying agent must notify the State Treasurer if sufficient funds are not transferred at least five days before the scheduled payment date. The State Treasurer then makes a loan to ensure punctual payment. In the event that the State Treasurer makes a payment, the State will intercept state aid payments due to the district plus interest and penalty fees. If this still proves insufficient, the State has the authority to issue GO bonds to reimburse depleted funds.

Since the inception of OSBG in 1997, no participating school district or college has requested that the State make a debt service payment on its behalf. While OSBG guarantees are a contingent liability of the State, this long track record of positive district financial management has meant that rating agencies do not consider OSBG as part of the State's overall general fund or net tax-supported debt.

Credit Features

Unlike bond insurers, the credit rating of the State and OSBG has increased over the last decade with current ratings of: AA+ by Standard & Poor's; Aa1 by Moody's Investors Service; and AA+ by Fitch Ratings. What differentiates OSBG from municipal bond insurance is the constitutional and statutory framework of the program, which provides credit enhancement features that have resulted in the program receiving the same credit rating the State receives on its GO bonds. Features of OSBG include: a pledge of the State's full faith and credit to guarantee payments, authorization of the State Treasurer to make intra-fund loans from State funds to a school district assuring immediate liquidity for all debt service payments, constitutional provisions authorizing the State Treasurer to issue property tax-backed GO bonds, Authorization of the State Treasurer to assure repayment of any draws on state funds to make debt service payments, including: use of the state school funds intercept mechanism or legal compulsion of a district or college to levy sufficient property taxes to repay any intra-fund loan or State GO bond sold on its behalf.

Local Benefits

For taxpayers and bond investors in the State, OSBG provides both credit enhancement and lower taxes through interest cost savings. The State of Oregon Debt Policy Advisory Commission estimates the State guarantee has saved Oregon taxpayers an average of 0.25% in borrowing costs with debt service savings on school bonds of roughly \$5 million per year, or \$104 million over a twenty year period. Furthermore, since the program does not have minimums, smaller school districts that would otherwise not have access to the capital markets benefit by being able to issue bonds with a AA+ rated issue at minimal cost through the OSBG Program.



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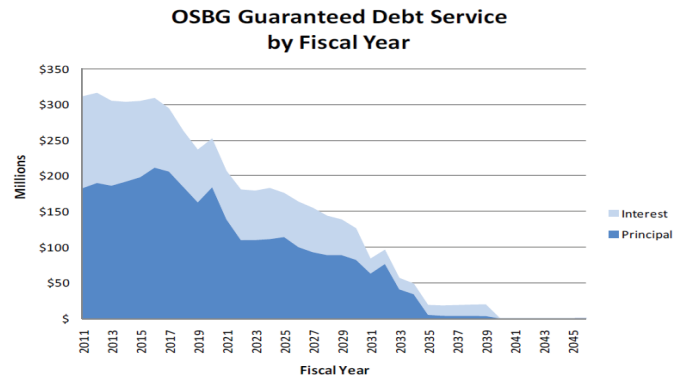
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The Future of OSBG

In a letter dated February 3, 2011 addressed to the Governor and Legislature, the State Treasurer wrote, "I believe that policy makers need to set prudent parameters on the upper limits of this program." For fiscal year 2011, OSBG applies to local school district debt service payments of \$311.5 million, which is equivalent to approximately 4.5% of total general fund revenues of the State for the fiscal year.



Source: State Debt Policy Advisory Commission Report, Dated February 16, 2011

Although rating agencies do not consider OSBG as part of the State's overall general fund or net tax-supported debt, OSBG presents a significant contingent liability of the State with an annual debt service guarantee at 4.5% of general fund revenues. The State Debt Policy Advisory Commission has recommended that the Governor and Legislature re-examine the use of both the OSBG program and other State aid intercepts to ensure the overall exposure of the State's general fund to local school bond debt service remain within financially prudent limits.

In May 2010, Oregon voters approved the passage of a Constitutional amendment authorizing the State to sell GO bonds to fund projects in those K-12 school districts which provide a cash match. The State has successfully been operating a similar type of bond program for higher education institutions and community colleges repaid from general fund resources. The new K-12 bond program combined with a debt limitation for the OSBG program would arm the State with increased discretion over contingent liabilities and the potential for negative credit exposure while still providing access to the capital markets for local school districts.

The OSBG is not an absolute guarantee that debt service payments will not be interrupted. For many investors, the decline in the use of bond insurance has placed greater focus on the underlying credit and the stability of the issuer. As investors, we carefully review the official statement for details on the mechanics of the OSBG to determine suitability.

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