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[Split Coupons Make Municipalities Pay Up in Low-Rate Environment.]

State and local issuers are resorting to betting on the future direction of interest rates to lure municipal-bond investors balking at tax-exempt yields not far from record lows.

When Aurora, Colorado, sold $437 million of water debt last month, its longest bond came with four different interest coupons — and four different yields, one of which exceeded the market level on similar securities that day. That means the city will pay four different interest rates on the debt issued for 30 years.

"What we're hearing from our investment bankers is that with rates so low, some investors are starting to balk," said Mike Shannon, who oversees Aurora's debt and investments. "We were willing to meet the needs of the investors to get these bonds sold, but if you look out at the long end, it gets pretty pricey."

Though it may be the best time in a generation to refinance, it doesn't come without costs. In some cases, despite a perceived shortage of munis, market rates are so low investors don't want bonds, forcing issuers to increase yields that can add millions of dollars in debt service. In a recent report, Samuel A. Ramirez & Co. advised investors they could earn more with split coupons, where lower coupons yield more than higher coupons.

''It's like a hidden yield," said Joy Howard, a financial adviser in St. Louis. "It's great for the investor, but terrible for the issuer."

The flat yield curve gives investors less incentive to buy bigger coupons because they don't get enough compensation for extra risk. Since the first of the year, the slope — or spread between yields of short and long maturities — has flattened from 214 basis points to as little as 164 basis points, or half a percentage point, the lowest since early 2008. In early 2014, it was nearly four percentage points.

With interest rates about as low as they can go, investors realize they may wind up holding longer bonds to maturity after rates increase. Bill Gross, who built Pacific Investment Management Co. into the world's largest manager of bond funds and is now at Janus Capital Group Inc., warned this week that any reversal of the rally could be painful.

"You're not getting paid to go out long," said Peter Block, managing director of credit strategy with Ramirez. "Why buy a 30-year bond when you can get paid nearly as much for a 12-year bond?"

The higher price for bonds with larger coupons is driving out individual investors, making it harder to sell some securities, Matt Posner, principal with the Court Street Group, a New York research firm, said in a report last month. New York's Metropolitan Transportation Authority split coupons in July.

"We're seeing municipal-bond yields lower then they've ever been before, so most issuers are locking in to take advantage," Posner said in an interview. "If they need to split some coupons and spend more, they're willing to do that."

Patrick McCoy, the authority's finance director, said the agency adjusts coupons in response to market conditions to get the lowest cost.

"We are seeing investors articulate frustration with the lower absolute yields," said McCoy.

In February, the Los Angles Unified School District split its 2040 maturity into two coupons, with one paying 4 percent and the other 5 percent, when it borrowed about $1.2 billion. The bond with the 4 percent coupon yielded 3.25 percent, more than a third of percentage point more than the higher-coupon security.

Splitting the coupons "was an effective technique that the district took advantage of to maximize" demand, district spokesman Gayle Pollard-Terry said in an e-mail. That let the district cut costs that would have come with only a single coupon. The actual yield that will be paid will depend on how long bonds are outstanding and whether they're refinanced.

"A bond with a higher coupon is more likely to be called than a bond with a lower coupon," the district said. "The reverse is true for a lower-coupon bond."

Aurora will monitor rates as its bonds mature and refinance the more expensive ones first, said Shannon. The cost of some of its bonds will rise after the 10-year call date, while the cost of others will fall. He said the unusual structure with four coupons, including one that steps up over time, was dictated by banks led by Morgan Stanley in handling the debt sale, who he said told him four coupons were necessary to sell the bonds. Morgan Stanley declined to comment through spokesman Mark Lake.

One coupon increases in steps from 2 percent in early years to 5 percent by the end of its 30-year term. One investor was willing to buy big chunks of the bonds in two maturities if the coupons were lowered. The 2.95 percent yield on the 3 percent bond maturating in 2046 was more than half a percent more than the yield on the 5 percent coupon.

"We had to increase the rates to bring in the investor," said Shannon. "But we think we will be able to take advantage of this structure and pay some of it off early. The question is whether the bond is going to stay out 10 years, 20 years or 30 years?"

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