OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Subject: Debt Policy

OVERVIEW

On June 6, 2007, the CFO and the Debt Management Director briefly introduced and provided an overview of a Debt Policy ("Policy"). The stated objectives of the Policy are to "establish guidelines for the use of various categories of debt; to create procedures and policies that minimize the City's debt service and issuance costs; to retain the highest practical credit ratings; and to provide full and complete financial disclosure and reporting." In recommending that the Policy be more fully discussed at a future meeting of the Budget and Finance Committee, the Committee asked that the IBA review and comment on the Policy. This report provides comments and considerations with respect to the Policy.

FISCAL/POLICY DISCUSSION

Why Develop a Debt Policy?

The City has never had a formal, written debt policy that comprehensively addresses parameters, procedures and goals for the issuance and administration of debt. The IBA commends the CFO and Debt Management Director for developing a policy that can be reviewed by the City Council and utilized by City staff. Government associations, rating agencies and financial best practices all support the development and utilization of a sound debt policy. Documentation elaborating on the rationale and utility of debt policies is provided within the Background Information section of the Policy. A few excerpts from that section are presented below:

- In their 2003 Recommended Practice for a Debt Management Policy, the **Government Finance Officers Association (GFOA)** provides: “A debt management policy improves the quality of decisions, provides justification for the structure of debt issuance, identifies policy goals, and demonstrates a commitment to long-term financial planning, including a multi-year capital plan. Adherence to a debt management policy signals to rating agencies and the capital markets that a government is well managed and should meet its obligations in a timely manner.”

- In recommending the adoption of policies to guide the issuance and management of debt, the **National Advisory Council on State and Local Budgeting** states: “Issuing debt commits a government’s revenues several years into the future, and may limit the government’s flexibility to respond to changing service priorities, revenue inflows, or cost structures. Adherence to a debt policy helps ensure that debt is issued and managed prudently in order to maintain a sound fiscal position and protect credit quality.”

- In their Elected Official’s Guide on Debt Issuance, the **GFOA** indicates: “A carefully crafted and consistently applied debt policy provides evidence to the rating agencies of a community’s commitment to prudent borrowing practices. As such, it is regarded positively in evaluating a jurisdiction’s creditworthiness.”

- Acknowledging that assessing managerial strength is essential and the most subjective of their five rating factors, **Moody’s Investors Service** cites Debt Planning as one of the six critical components of strong municipal management.

As stated in the Overview on page 2, the City’s Policy is designed to:

- Establish parameters for issuing and managing debt;

- Provide guidance to decision makers related to debt affordability standards;

- Document the objectives to be achieved by staff, both pre- and post-issuance;

- Promote objectivity in the debt approval decision making process; and

- Facilitate the actual financing process by establishing important policy decisions in advance.

<u>Purpose and Need for Financing</u>

Chapter I of the Policy discusses the purpose and need for financing. This chapter states that debt will only be used to finance eligible projects when it is the most cost-effective means to the City. The pay-as-you-go method of using current revenue to fund capital projects is often considered to be the least expensive means of financing because it avoids interest payments; however, this method is not always equitable (because current taxpayers pay for assets with long useful life expectancies that will benefit future generations of taxpayers) or practical (because many large expense capital projects will require years of tax accumulation before desired public assets can be built or acquired).

It is typically a good financial practice to try to match the term of debt issuances to the expected useful life of the assets being financed. The Policy specifies that debt will only be used for a capital project when it is an appropriate means to achieve a fair allocation of cost between current and future beneficiaries and if a secure revenue source is identified to repay the project.

In describing how financing priorities are determined, the Policy indicates that all borrowing requests will be reviewed by the CFO. The policy further provides that the Department of Finance will work with the Public Works unit to assess the feasibility and impact of debt based on: how the project furthers the City's policy objectives; cost-benefit considerations; expenditure plans; and plans for debt repayment. It may be useful for the Committee to learn more about the current process for prioritizing and sizing debt recommendations.

For example, the CFO recommended that $33 million be spent for deferred maintenance of the City's storm drains and streets in the FY 2008 Proposed Budget, with 75% of this amount to be financed from debt. Given an estimated $800 to $900 million of General Fund deferred maintenance needs and other competing financing requests, the Committee might ask how this recommendation was developed in relation to the Policy.

Additionally, the Policy does not mention the fiscal importance of assessing/funding the necessary operating costs for new debt-financed facilities and equipment. While this could be regarded as a budget policy consideration, operating costs represent a related fiscal impact that should be considered in determining debt financing priorities. The IBA recommends that the Committee discuss new facility/equipment operating costs with the CFO in the context of planning for and prioritizing debt financed capital projects.

<u>Debt Affordability Guidelines</u>

Chapter IV of the Policy discusses generally accepted measures of affordability for General Fund-supported debt (general obligation bonds, lease revenue bonds and certificates of participation) and revenue bonds (i.e., enterprise fund debt). Fitch Ratings indicates that debt affordability policies are a set of targets or ranges that measure debt levels against economic and financial indicators. In IBA Report Number 07-46, we evaluated the three General Fund-supported debt measures identified in the Policy.

Affordability Guideline	Typical Debt Policy Limit	Current City	Comment
1) Outstanding General Fund debt as a % of the market value of taxable property in the City.	2% to 5%	Approximately .3%	Very Low
2) Outstanding General Fund debt divided by the City's population - direct debt per capita.	$2,000 to $3,000 per capita	Approximately $369 per capita	Very Low
3) Total debt service for outstanding General Fund debt as a % of the General Fund budget.	High range: 8% to 12%	Approximately 4.5%	Low to Moderate

In the FY 2008 Proposed Budget, it states that the City will use General Fund-supported debt to finance approximately $380 million of $500-$600 million of deferred maintenance and capital needs that are expected to be funded over the next five years. Based on the above Policy affordability measures, the City's current General Fund-supported debt position is conservative and should be favorably evaluated by the rating agencies. These measures collectively suggest that the City has ample capacity to prudently issue debt to address various capital needs going forward. With respect to revenue bonds, the City often contractually promises bond buyers that the target 110% debt service coverage will be maintained.

Variable Rate Financing and the Use of Derivatives

Chapter V of the Policy discusses interest rate structure and the possible utilization of variable rate debt. Most of the City's debt has been structured as straightforward fixed interest rate transactions. In presenting debt options and structuring guidelines to the Budget and Finance Committee in August 2006, the CFO stated a strong personal preference for variable rate debt because he believed that, over the long run, the City could save money with this structure instead of fixed rate debt. The Policy mentions that general rating agency guidelines indicate that 20% to 25% of outstanding debt can be in a variable rate mode without representing undue risk. As the City is moving closer to having its credit ratings restored and re-entering the public capital markets, the Committee may wish to hear the CFO's current thoughts with respect to the benefits/considerations associated with integrating variable rate financing into the City's total portfolio of outstanding debt.

The appropriate use of derivatives in structuring debt is presented in Chapter V and in a portion of the GFOA Recommended Practice behind Tab 1 in the Policy. Derivatives are defined as securities that are based on, or derived from, an underlying asset, reference date or index. The Policy states that derivative products may be considered in order to achieve specific financial objectives consistent with the City's overall financial strategy. Cited examples of such financial objectives include: providing a better match between the interest rates on the City's debt and its investments; reducing the overall cost of borrowing; managing interest rate risk; and providing greater financial flexibility than would be available with a fixed rate structure. Because debt transactions involving derivatives tend to be more complex and carry unique risks, the Committee or Council may wish to request extra time to review and understand the rationale/benefits/risks associated with this type of transaction before they are asked to approve its utilization.

Post-Issuance Administration

Post-issuance administration of debt is presented in the last chapter (Chapter IX) of the Policy. The post-issuance chapter discusses the investment of bond proceeds, arbitrage compliance, ongoing disclosure requirements and compliance with other bond covenants. The IBA believes that the post-issuance administration of debt is just as important as any of the considerations associated with new debt. Tab 7 of the Policy lists over 90 City financing transactions worth approximately $3.4 billion. Most of these transactions carry a combination of federal, state, local and bond compliance requirements that are of utmost importance to bondholders and capital marketplace. Failure to fulfill these requirements can adversely impact our ability to efficiently borrow from the capital markets and be detrimental to credit ratings that the City is working hard to restore.

CONCLUSION

The IBA finds the parameters/objectives/goals of the Policy to be reasonable and typical of municipal debt policies. We commend the CFO and Debt Management Director for bringing the City's first written debt policy forward for Committee review and discussion. The timing for discussion of the new Policy is excellent as the City appears to be close to being able to re-access the public capital markets with pent up demand for public borrowings.

As noted above in the GFOA's 2003 Recommended Practice, a debt management policy can improve the quality of decisions, provide justification for the structure of debt issuance, identify policy goals, and demonstrate a commitment to long-term financial planning, including a multi-year capital plan. Given the anticipated financing activity on the City's horizon, the IBA recommends that there be additional Committee or City Council discussion of the Policy as it evolves, on an annual basis as is done with the City's Investment Policy. As part of the recently adopted City Council financial training program, the City Council is scheduled to receive training on debt issuance and administration on September 17, 2007. The training will provide the City Council with another opportunity to discuss aspects of the Policy.

The IBA has suggested within this report that the Committee may also wish to discuss the following issues with the CFO as they relate to the Policy:

- What is the current process for prioritizing and sizing debt recommendations?
- How was the deferred maintenance financing recommendation developed and sized for inclusion into the FY 2008 Proposed Budget?
- How will necessary operating costs for new debt-financed facilities & equipment be assessed in developing and prioritizing debt recommendations?
- What are the current thoughts with respect to benefits & considerations associated with integrating variable rate financing into the City's total portfolio of outstanding debt?
- The need for extra time to review and understand the rationale/benefits/risks associated with the use of derivatives in debt transactions.
- The possibility of an annual Policy review to provide the CFO and the City Council with an opportunity to discuss project prioritization and the anticipated forward debt financing calendar.

Finally, the IBA believes that it is critical that the City continue to monitor its outstanding debt and comply with all of the stipulated requirements. Excellent post-issuance administration of debt ensures that the City's bond offerings will be favorably received by the capital markets and avoids problems with debt regulators. Resources for these activities should be provided as needed to facilitate thorough compliance.

[SIGNED]	**[SIGNED]**
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