OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Item Number: 1

Subject: Discussion of Proposed Debt Policy

OVERVIEW

On July 25, 2007, the Debt Management Director and CFO presented a new Debt Policy to the Budget Committee for consideration. The IBA presented comments on the Policy as provided in IBA Report #07-70. Following discussion by members of the Budget Committee, the Committee requested that the CFO, City Attorney and the IBA return with information to address comments and concerns related to the Policy.

The CFO issued a memorandum and a revised Policy ("Policy") dated September 18, 2007. Additionally, the CFO issued a memorandum on the same date responding to questions raised in a memorandum from Councilmember Frye dated July 31, 2007 (Attachment 1). This report comments on the Policy and items that were discussed at the Budget Committee meeting on July 25, 2007.

FISCAL/POLICY DISCUSSION

The IBA has reviewed the Policy and the two memoranda provided by the CFO on September 18, 2007. In his memorandum accompanying the Policy, the CFO endeavors to address most of the items discussed, and information requested, by the Budget Committee on July 25, 2007. IBA commentary on the CFO's responses and revisions to the Policy are provided below:

Definition of Debt

Noting that significant financial obligations of the City (particularly pension liabilities and Other Post Employment Benefits – "OPEB") were not included in the City's Policy, Councilmember Frye raised the question of what types of financial obligations should be included in the City's Policy and which should be excluded. The CFO has responded that the Policy primarily addresses debt instruments/securities issued by the City in public or private bond markets. The IBA concurs with the CFO's statement that this is consistent with examples of debt policies in other comparable municipalities, Government Finance Officer Association ("GFOA") guidelines and rating agency guidelines.

The IBA supports the addition of the second paragraph on page two of the Policy that defines the debt that is addressed by the City's Policy and discusses those financial obligations that are not covered (specifically excluding the pension and OPEB unfunded actuarial liabilities). As noted in the GFOA Elected Official's Guide on Debt Issuance, debt policies are intended to establish parameters and to provide general direction in the planning and implementation of a debt program, where debt is discussed in a bonded indebtedness context. Pension and OPEB liabilities are disclosed in the City's financial statements and other actuarial reports that are available to investors and the public.

Prioritization Process for Capital Improvement Projects

As presented in IBA Report #07-70 and at the Budget Committee meeting on July 25th, the IBA recommended that the City develop a comprehensive process for prioritizing capital improvement projects ("CIP") so that the City Council would have a better understanding of what they are being asked to finance and how priority is determined. In response to the IBA recommendation and Committee direction, the Mayor's Assistant Deputy Chief of Public Works convened a meeting of senior department officials on August 21st. Different City departments with differing CIP needs were represented and the goal was to brainstorm a framework for a new CIP prioritization policy. The IBA was invited to participate in the meeting and has recently been provided with a preliminary draft of a CIP prioritization policy. It is our understanding that the draft CIP prioritization policy continues to be developed and will be presented to the Budget Committee next month.

The forthcoming CIP Prioritization Policy is prospectively referenced on page four of Chapter I of the Policy (section 1.1. – A.). In response to the IBA's concern that operating costs for facilities and equipment be factored into any decision to issue debt, this same section of the Policy now provides that "necessary operating costs associated with any capital facilities and equipment, including those financed through debt, will be determined during the budgeting process". The IBA recommends that this sentence be clarified to indicate that operating costs will be discussed before or when debt is approved instead of waiting for funds to be identified in a subsequent budget process. The IBA otherwise supports these two additions to the Policy.

Types of Debt Instruments/Securities Covered by the Policy

Chapter III of the Policy briefly describes the different types of long-term and short-term financing instruments the City can utilize. In response to the IBA's suggestion, section 3.10 has been added to describe the Multifamily Mortgage Revenue Bonds that are issued by the City's Housing Authority.

As discussed on page 23 of the Policy, the Disclosure Practices Working Group ("DPWG") is charged with reviewing all of the types of bonded indebtedness described in Chapter III for compliance with all applicable securities law. It should be mentioned, however, that some of the debt described in the Chapter III (notably Redevelopment Agency and Housing Authority financings) receive limited structural/technical oversight from the CFO/Debt Management Department. This debt may not be governed by the issuing parameters described within the Policy.

These agencies/authorities are typically accorded some fiscal autonomy with respect to structuring and pursuing their debt. The Council may wish to request that their respective boards/ commissions develop specific debt policies or procedures to incorporate into the Appendix section of the City's Policy. This would enhance reader understanding and foster greater policy integration.

Debt Affordability Measures

Sections 4.1 through 4.3 of Chapter IV of the revised Policy describe affordability measures that the City can use to assess its capacity to prudently issue additional debt in the eyes of the rating agencies. IBA Report #07-70 calculated some of these measures to show that the City possesses a relatively low amount of General Fund-supported debt and has capacity to issue additional debt. It is, however, important to point out that while the City's "capacity" to issue debt might appear to be strong; the General Fund has limited discretionary revenues to afford additional annual debt service commitments. The General Fund is significantly constrained by competing demands for service, maintenance and facility expenditures (as well as other obligations like the unfunded pension and OPEB liabilities).

In her memorandum dated July 31, 2007, Councilmember Frye requests that debt affordability or capacity measures include the unfunded pension and OPEB liabilities. In his response, the CFO indicates that the debt affordability ratios are guided by rating agency methodology standards and should only include general obligation bonds and

General Fund-backed bond obligations. The IBA concurs with the CFO's position on the methodology for calculating these prescribed affordability ratios.

In a Fitch Ratings article entitled "To Bond or Not To Bond – Debt Affordability Guidelines and Their Impact on Credit" (see Attachment 1 - the last attachment to the CFO's response), Fitch specifies that they do not include unfunded pension or other liabilities in their affordability ratios. They are, however, very aware of these liabilities and do factor them into their ratings of municipalities. Debt affordability ratios are but one of several important factors that rating agencies use to determine an overall credit rating. Credit ratings can be helped or hurt by whether or not a municipality has established a sound plan for systematically addressing significant unfunded liabilities. Rating agencies look at budgetary plans and funding commitments to address unfunded liabilities rather than debt affordability measures.

Variable Rate Debt and the Use of Derivatives

Chapter V of the Policy discusses interest rate structure and the possible utilization of variable rate debt and/or derivative options. The IBA has suggested that the Council learn more about the benefits/considerations associated with variable rate debt or derivative options before they are asked to approve such a debt structure. At the Budget Committee meeting on July 25th, the CFO indicated that he would be developing a policy for City Council consideration that would establish parameters for the use of variable rate debt or derivative options.

In the cover memorandum to the revised Policy, the CFO provides that he will conduct a City Council workshop on variable rate debt and derivative options. The Policy, however, only indicates that the CFO will work with the Debt Management Director and the City Treasurer to evaluate the City's debt portfolio and review City assets and liabilities in deciding whether or not to use variable rate debt. The IBA supports the commitment to provide a City Council workshop and further recommends that a Variable Rate Debt and Derivatives Options Policy be developed and approved by the City Council as an outcome of that workshop. The resulting Variable Rate Debt and Derivatives Options Policy could then be specifically referred to in Chapter V and also included in the Appendix section of the City's Policy.

Other Related Policies

In presenting the new City Policy, the CFO is recommending that the current version of City Council Policy 800-03 be repealed. The CFO recommends that the same repealed policy be simultaneously incorporated into the Appendix of the new Policy, with a few modifications intended to strengthen the credit of the City's land-backed debt and also provide for more flexibility in the utilization of funds. Specifically, the recommended modifications would increase the collateralization requirement from 3:1 to 4:1; reduce the maximum special tax that can be levied on a parcel; add requirements to strengthen credit quality; and allow funds to be increasingly used for maintenance and/or operational costs. The IBA supports the recommended modifications and the suggestion to incorporate a modified version of Council Policy 800-03 into the Appendix section of the new Policy.

Additionally, the IBA recommends that the CIP Prioritization Policy, Variable Rate Debt and Derivatives Options Policy, and any other debt-related policies be incorporated into the Appendix section of the new Policy. The core Policy could then refer to the Appendix when discussing debt-related parameters, structures or other issues. The goal would be to have an overarching Policy that brings together all of the City's other debt-related policies into a single document for reference and guidance.

City Council's Role in Approving the new Policy

On page three of the Policy, the CFO provides "in the event there are any deviations or exceptions from the debt policy when a certain bond issue is structured, those exceptions will be discussed in the staff reports when the bond issue is docketed for City Council consideration". The IBA believes that this is an important commitment that 1) provides policy flexibility in the event of changing City and/or market conditions and 2) ensures that Councilmembers will be apprised of any proposed deviations from the Policy before they are asked to approve a debt issuance.

The Policy further specifies on page three that, after adoption, the Policy will be returned to the City Council bi-annually for City Council review and consideration of possible changes. The GFOA Elected Official's Guide on Debt Issuance "recommends that all state and local governments adopt comprehensive written debt management policies and that these policies be reviewed at least annually and revised as necessary". The City Council may wish to discuss an appropriate timeframe for reviewing and considering amendments to the Policy in light of the GFOA's recommendation for an annual review.

CONCLUSION

If adopted, the recommended Policy would be the City's first written debt policy. The Policy sets forth objectives, parameters and conditions for issuing debt; provides an informational overview of the different types and structures of City debt; explains how debt issuances are developed and reviewed; and provides the Mayor & City Council with a guiding document for thoughtful debt issuance. The timing for discussion of this 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.

The IBA applauds the CFO's effort and initiative in bringing forward a comprehensive Policy for Budget Committee review and discussion. Provided that the CFO develops and references the important debt-related policies as discussed above (a CIP Prioritization Policy and a Variable Rate Debt and Derivatives Options Policy in particular; Redevelopment Agency and Housing Authority policies should also be considered), the IBA recommends that the Budget Committee support City Council adoption of the new Policy as is recommended by the GFOA.

[SIGNED]

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[SIGNED]

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Attachment