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City of Alexandria, Virginia

MEMORANDUM

DATE: FEBRUARY 22, 2017

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: MARK B. JINKS, CITY MANAGER /s/

DOCKET TITLE:

Proposed Amendments to the City's Debt-related Financial Policies.

ISSUE: Amendment of the City's debt policy guidelines to better balance the City's ability to pay for increased capital investment needs and the need to maintain the City's top AAA/Aaa bond ratings

RECOMMENDATION: That City Council, at the time of the May adoption of the FY 2018 budget and FY 2018 to FY 2027 Capital Improvement Program, amend the City's Debt Policy Guideline to:

- (1) Increase the Debt to Tax Base Ratio from 1.6% to 2.5%
- (2) Increase the Debt Service as a Percent of General Expenditures from 10% to 12 %
- (3) No longer utilize Debt as a Percent of Personal Income as a debt ratio measure
- (4) Recognize only Tax-Supported Debt and Tax-Supported Debt Service as appropriate for debt ratio measure calculations
- (5) Include debt repayment rapidity ratios of 50% as a minimum 10-year repayment ratio and 65% as the target 10-year repayment ratio as new elements of the written debt policy guidelines.

BACKGROUND: The City's Debt-related Financial Policies were initially adopted in 1987. These guidelines when they were adopted were considered innovative by the bond rating agencies, and those debt-related financial policies have been used as a model by other localities. The policies were substantially updated in 1997. With the exception of a few minor changes since then, these policies have continued to guide Council and staff in financing the capital improvement program of the City, managing the impact of debt service on the operating budget and maintaining adequate fund balances to cope with unexpected financial problems or emergencies.

The City has established policies to help guide financial decisions and ensure that spending decisions are made through the lens of sound financial management. Across the country there are 282 cities, counties and towns who possess a Aaa rating from Moody's Investor Service out of a possible 25,859 entities. The City's credit worthiness has long received the highest rating from Moody's (Aaa), as well as Standard and Poor's Ratings Services (AAA), indicating that Alexandria has an extremely strong capacity to meet financial commitments.

The impact that these two top bond ratings have is to enable the City to borrow money at the lowest possible interest rates, reducing the cost of building and maintaining assets, and enabling the City to spread the cost of the asset over its useful life (i.e., "intergenerational equity sharing" or "pay-as-you-use"). In as much as the City's debt management policies have enabled the City to reduce costs over time, it is equally important that these policies are flexible enough for the City to take advantage of economic opportunities and maintain its investments. A well-crafted debt management policy should provide the ability for a locality to maintain and protect its facilities and infrastructure and enable its governing body to respond to the changing investment needs of the community.

DISCUSSION:

Proposed FY 2018 to FY 2027 Capital Improvement Program

The City is currently faced with numerous significant capital investment needs in its fundamental areas of responsibility: public transit safety and reliability, environmental infrastructure, facility "state of good repair," and public school capacity. The Proposed FY 2018 to FY 2027 Capital Improvement Program assumes a substantial amount of borrowing (\$0.8 billion) to fund General Fund-supported capital infrastructure needs. In addition to that amount are \$348.9 million in bonds for the Sanitary Sewer projects backed by Sanitary Sewer fees, and \$41.2 million in bonds for stormwater management projects backed by Stormwater Utility fees.

While the ten-year CIP includes additional borrowing, the plan also assumes the re-payment of \$746.3 million in principal payments on prior year and planned bond issuances. Of this \$746.3 million in principal payments, \$118.3 million will be paid through Sanitary Sewer fees, Stormwater Utility fees, and Potomac Yard generated taxes and developer contributions. The debt service on the remaining bonds will be paid back through the City's General Fund. Based on prior reviews by, and discussions with Moody's and Standard & Poor's bond rating agencies, this amount of debt is consistent with debt ratios that would not risk the City's AAA/Aaa bond ratings. Additional borrowing will impact the annual operating budget through increased debt service payments.

It is important to note that debt is only one part of the evaluation that the rating agencies consider in their analysis. Generally, the agencies assess their ratings based on a jurisdiction's economy and tax base, overall finances and fund balance, management and debt/pensions. Having a debt policy is critical and managing within that policy is very important. Reconsidering the policy for sound, carefully planned operational decisions is not viewed unfavorably and previous discussions with both rating agencies of the City's intent to

make a significant long term investment in the City's tax base have been positive.

The intent of the City's debt-related financial policies is to provide written, clear guidelines and a framework for defining what the City, and its citizens, has the ability to finance. The City currently has three debt-related financial ratios:

- Debt as a Percent of Fair Market Real Property Value
- Debt as a Percent of Total Personal Income
- Debt Service as a Percent of General Government Expenditures

Enterprise Fund-Related Debt

Part of the purpose of modifying the current debt-related policies is to recognize that the City has and will be issuing debt that is not reliant on the general tax base. The primary example is debt service for the sanitary sewers, which is funded by user fees charged to households and businesses that are connected to the sanitary sewer system. It should be noted that sanitary sewer debt is considered "double-barreled" debt in that it is issued as general obligation debt (in order to take advantage of the City's AAA/Aaa general obligation debt's ultra low interest rates) but it is actually repaid with stable and reliable user fees. As such, this type of debt is considered enterprise fund debt and is therefore not typically included in jurisdictional debt ratio calculations. This has been the City's practice with sanitary sewer fee-backed debt, and in 2018 this will become the practice for storm sewer fee-backed debt, since the City will be adopting a stormwater utility fee starting in calendar year 2018. The proposed revised Debt-Related Financial Policies will reflect this debt ratio calculation methodology of excluding enterprise fund-related sanitary and stormwater sewer debt from the City's debt ratio calculations.

Current Debt-related Financial Ratios

The information below shows our current adopted targets and limits. There are currently three ratios that are used to guide and evaluate our decisions: debt as a percentage of total personal income, debt as a percentage of the city's real estate tax base and debt as a percentage of operating expenditures.

- Debt as a Percent of Fair Market Real Property Value
 - Target = 1.1%
 - Limit = 1.6%
- Debt as a Percent of Total Personal Income
 - Target = 3.2%
 - Limit = 4.5%
- Debt Service as a Percent of General Government Expenditures
 - Target = 8.0%
 - Limit = 10.0%

In addition, the City currently has one ratio related to the amount of Cash Capital budgeted each year compared to General Fund Expenditures.

- Cash Capital as a Percent of General Fund Expenditures
 - Target 2.5%
 - Floor = 2.0%

Debt is only a portion of what the rating agencies look at to determine the City's creditworthiness. However, it is important for the City to remain consistent with its peer jurisdictions in terms of debt policies. The ratios of debt to the tax base and governmental expenditures are important indicators of the City's ability to pay for capital investments. It is important to keep in mind that debt service payments and capital improvements represent only a portion of the spending needs of a locality. Investments in capital improvements must be weighed each year against other spending demands in areas such as social services, public safety and other operational expenses. Limited resources will always require the City to prioritize investments of all kinds, regardless of the limits that are set related to debt. Increasing the City's debt-related financial policy debt ratios will increase the flexibility the City has to make investments in the City's capital infrastructure, but the debt ratios are only one factor to consider in terms of budget decisions.

A. Debt as a Percentage of Real Property

This ratio compares the City's total outstanding debt at a point in time with the market value of its total taxable real property. Based on analysis by Davenport and Company (the City's financial advisors), which uses the latest available audited financial information of our peers, the City's debt compared to real property is 1.39%, which is below the City's peer average (Attachment 1). A survey of 40 AAA/Aaa jurisdictions (Attachment 2) across the country with similar population and demographics as Alexandria showed an average established policy limit of 3.0%. (excluding California cities where Proposition 13's impact distorts this ratio) Alexandria's current limit of 1.6% is well below the average of its peers. It is also below the City's immediate neighboring jurisdictions. Arlington, Fairfax and Prince William Counties have a ratio limit of 3.0%. Loudoun and Montgomery County have limits of 1.5%. Staff recommends raising this limit to 2.5%, as well as eliminating any numerical target. In effect, the City's CIP each year will set a target based upon the level of tax-supported debt it proposes.

B. Debt as a Percentage of Personal Income

This ratio compares the City's total outstanding debt at a point in time with the aggregated personal income of the City's residents. In previously published documents, the City's personal income as provided by the Bureau of Economic Analysis for 2013 (the most recent year for which it was available) was \$12.1 billion. All previous models used this number as the base for projections. In November 2015, the BEA restated the calendar year 2013 estimate to \$11.2 billion, which was a reduction of 7 percent compared to the original estimate. The new calendar year 2014 personal income total for Alexandria is \$11.6 billion. The restatement and new estimates are the result of a change in the source of the information and the methodology for handling data related to commuters.

Staff recommends that this ratio be eliminated from the official debt policy. Rating agencies do not look at this as a factor for localities, only for state credit ratings, as most states have income taxes as a primary revenue source. Additionally, as evidenced above, the City does not control the calculation methodology making this ratio vulnerable to external drivers. Other demographic information is available that speaks to the wealth levels of the residents, including per capita income, average wage per job and unemployment rates. Another key indicator of the wealth of the community is the average assessed value of the property tax base in Alexandria, which is a direct indicator of the wealth of the community.

C. Debt Service as a Percentage of General Government Expenditures

General Government Expenditures includes all expenditures for the City, the Schools, the Libraries and our contributions for Transit, plus the current year costs of the Capital Improvement Program. The purpose of this

ratio is to ensure that debt service is maintained as an appropriate portion to overall spending. The City's policy currently sets of a target of 8 percent and a limit of 10 percent. Other Northern Virginia jurisdictions with a 10 percent limit are Arlington, Fairfax and Prince William Counties. The comparator jurisdictions reviewed by Davenport reflected a minimum of 7.8 percent and a maximum of 20 percent. Staff recommends that this ratio be increased to 12 percent limit. Of the 40 jurisdictions surveyed, 22 have a debt policy related to General Government Expenditures and the average limit is 11.5 percent. This debt ratio also needs to be increased due to the fact that the City has shifted its new spending priorities from operating programs to capital investments over the last decade. It is also proposed that the numerical target be eliminated as the City's operating budget and CIP each year will set a target based upon the level of operating expenses as well as the level of tax supported debt that the CIP proposes.

D. Cash Capital as a Percentage of General Government Expenditures

Several years ago, City Council passed a policy to limit the use of cash capital for funding the CIP. The minimum or floor was set at 2.0% and the target was set at 2.5%. Staff does not recommend any changes to these ratios.

E. Payout Ratio for Outstanding Debt

One of the areas in which local governments are evaluated by the bond rating agencies is the speed of repayment of outstanding debt. Jurisdictions whose payout ratios are greater than 65 percent are viewed more favorably. The payout ratio compares how much debt is structured to be paid off in a given period of time. A more aggressive repayment structure results in a higher ratio. The City frequently structures its debt with level principal payments across the life of the debt, but sometimes will staircase up its principal repayment in the first few years of principal repayment before level principal repayment starts. Staff recommends that City Council endorse a strategy of paying off all 20-year General Fund tax-supported debt at a minimum repayment rate of 50% in the first 10 years, with a target repayment rate of 65%. Excluded from this measure would be major capital projects where the life span of the project will likely substantially exceed a 20-year repayment time period. The Potomac Yard Metrorail Station (30 years) and the sanitary sewer CSO projects (TBD) are two examples of projects that would be excluded from this repayment ratio calculation. Including the most recent debt issuance, the payout ratio for the City was a very positive 67%, meaning within 10 years more than 66 percent of the City's outstanding debt is structured to be paid.

After the presentation of these proposed debt ratios to City Council on February 28, the City's Budget and Fiscal Affairs Advisory Commission (BFAAC) will be requested to review these proposed changes and to make recommendations to Council prior to the budget and CIP adoption on May 4.

FISCAL IMPACT: This action has no direct fiscal impact. If this recommendation is adopted, financial decisions and decisions to invest in the FY 2018 to FY 2027 Capital Improvement Program will need to conform to the new debt ratios without debt associated with Sanitary Sewers and Stormwater Management. Attachment 2 provides graphs showing the impact of the proposed CIP and planned debt issuance compared with the new ratios.

ATTACHMENTS:

1. Current debt ratios compared to 5 DC area peer jurisdictions
2. Survey of AAA/Aaa Jurisdictions Debt Policies
3. Staff Presentation

STAFF:

Laura Triggs, Deputy City Manager

Kendel Taylor, Director of Finance

Morgan Routt, Director, Office of Management and Budget

Michael Stewart, Deputy Finance Director

Arthur Wicks, Capital Budget Analyst, Office of Management and Budget