

MANAGING DEBT CAPACITY

Taking a
Policy-Based
Approach
to Protecting
Long-Term
Fiscal Health

BY BILL STATLER



A former city manager for the City of San Luis Obispo, California, said, “Any idiot can borrow money. The genius part is being able to pay it back.” The Great Recession has certainly underscored the truth of this observation and reminded everyone that a policy-based approach to debt affordability provides an essential foundation for the “genius” part of debt management: paying it back.

LAYING THE FOUNDATION FOR FISCAL HEALTH

Many factors determine a jurisdiction’s long-term fiscal health, but the single most important ingredient is developing and articulating clear fiscal policies *before* financial crises hit. They will help avoid fiscal crisis to begin with; and they will help the organization respond in a prudent manner during times of financial stress.

Local governments exist to make our communities better places to live, work, and play; fiscal health is not their reason for existence. But to achieve its goals, a community needs the fiscal capacity to link those goals with the necessary resources. And this is rarely a matter of luck. A strong local economy makes a difference, of course, but financial management is the most critical factor. Look at the \$1 billion Orange County bankruptcy. It did not occur because of an underlying weakness in the local economy but because the county didn’t have appropriate investment policies (or didn’t follow them).

Any debt issuance should be preceded by longer-term financial and capital improvement plans that address these fundamental questions:

- What does the jurisdiction plan to do, and why?
- How does the jurisdiction plan to pay for it?
- What’s the “right” combination of pay-as-you-go versus debt financing?

Plans change over time as actual results replace assumptions, but policies don’t. Policies serve as a guidepost that jurisdictions can look at when making plans, making tough decisions easier by laying out the organization’s values before they are placed under stress by adverse circumstances. Even if you choose not to follow the policy, at least it provides a good place to start.

Exhibit 1: 1996 General Fund Reserve Survey

City	Policy?	Description	Actual
Arroyo Grande	No		1 percent
Atascadero	No		1 percent
Grover Beach	Yes	20 percent of operating	20 percent
Morro Bay	Yes	27.5 percent of operating	15 percent
Paso Robles	Yes	15 percent of operating	13 percent
Pismo Beach*	No		-14 percent
San Luis Obispo	Yes	20 percent of operating	21 percent

*A case can be made for almost any level of reserves, but it should at least be zero.

THE CITY OF SAN LUIS OBISPO’S EXPERIENCE

In 1996, the San Luis Obispo City Council asked staff to prepare a summary of the city’s finances, compared with the six other cities in the county. Along with a number of other financial measures such as revenues and expenditures per capita, San Luis Obispo asked the other cities if they had formal minimum general fund reserve policies, and if so, what they were, and how their actual results compared with their policies.

Exhibit 2: 2006 General Fund Reserve Survey

City	Policy?	Description	Actual
Arroyo Grande	Yes	20 percent of operating	20 percent
Atascadero*	Yes	Narrative assessment	44 percent
Grover Beach	Yes	20 percent of operating	23 percent
Morro Bay	Yes	27.5 percent of operating	14 percent
Paso Robles	Yes	15 percent of operating	39 percent
Pismo Beach	Yes	15 percent of operating	15 percent
San Luis Obispo	Yes	20 percent of operating	21 percent

*Actual shown as a percentage of the operating budget.

Exhibit 3: San Luis Obispo's Budget and Fiscal Policy Areas

- Financial Plan Purpose and Organization
- Balanced Budget
- Financial Reporting
- General Revenue Management
- User Fee Cost-Recovery Goals
- Enterprise Fund Fees and Rates
- Revenue Distribution
- Investments
- Appropriations Limits
- Minimum Fund Balance
- Capital Improvement Management
- Capital Financing and Debt Management
- Human Resource Management
- Productivity
- Contracting for Services

As Exhibit 1 shows, not all cities with policies had the same ones, or had fully achieved them. However, those cities with articulated policies were clearly in better financial condition than those without them. Exhibit 2 shows the results of a follow-up survey ten years later, when all of these cities in the county had adopted minimum reserve policies and were closely following them.

San Luis Obispo has used formal policies as an integral part of its financial planning and budgeting process for more than 20 years, which has served the city well in both good times and bad. (The fact is that for most governments, the roots of fiscal adversity take hold in the good times, when they make commitments that are not sustainable.) As shown in Exhibit 3, the city's budget and fiscal policies, which are included in its budget document, cover a broad range of areas. (The document is available for download on the city's Web site at www.slocity.org/finance/policies.asp.) Of these, the debt management policies have played an especially important role in preserving the city's long-term fiscal health.

PREPARING DEBT MANAGEMENT POLICIES

There are no right answers in preparing debt management policies, only right questions. These include:

- Who prepares them?
- Who approves them?
- Who sees them?

Exhibit 4: Fitch Ratings: Best Practices

Impact on Ratings

Very Significant

- Fund balance policy
- Debt affordability reviews and policy

Significant

- Pay-as-you-go capital financing
- Multi-year forecasting
- Monthly or quarterly reporting/monitoring
- Quick debt retirement

Influential

- Contingency plans
- Non-recurring revenue policy
- Depreciation of fixed assets (GASB 34 implementation)
- 5-year capital improvement plan integrating operating cost impacts
- GFOA financial reporting award
- GFOA budgeting award

- Who is the audience?
- How detailed should they be?
- How often are they reviewed and updated?

The importance of effective debt management policies is reflected Exhibits 4 and 5, which summarize the role fiscal policies play in the formal assessment process of two major credit ratings agencies, Standard & Poor's and Fitch Ratings. In each case, debt affordability is a key factor in assessing financial strength.

Exhibit 5: Standard & Poor's Top 10 Practices

Financial Management Assessment Methodology

- Established budget reserve
- Regular economic and revenue reviews
- Prioritized spending plans and established contingency plans
- Formal capital improvement plan
- Long-term planning
- Debt affordability model
- Pay-as-you-go financing
- Multi-year financial plan
- Effective management and information systems
- Well-defined and coordinated economic development plan

Evaluating the debt management practices of comparable agencies can be a useful approach in assessing your agency's debt capacity. The key steps are establishing benchmarks, analyzing the organization's current debt position, and incorporating the findings into debt policies.

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Establishing the Benchmarks. There are three key factors to consider in establishing the benchmarks for comparison:

1. *What debt should be included?* General obligation debt only? Or all tax-secured debt, such as short-term notes, special tax, "moral obligations," tax increment bonds? Should it also include revenue bonds such as water, sewer, power, airports, harbors, parking, and golf operations? How about capital lease debt such as certificates of participation, lease-revenue bonds, and lease-purchase agreements? And how should any self-supporting debt be addressed?
2. *What indicators should be used?* A wide range of indicators might be included in the assessment, such as net direct debt as a percentage of assessed value or fair

value market value; net direct debt per capita; net direct debt as a percentage of personal income per capita; net direct and overlapping debt per capita; rate of repayment (e.g., the percentage principal within five, ten, or more than ten years); debt service per capita; debt service per capita as a

percentage of personal income per capita; debt service as a percentage of general fund revenues; debt service as a percentage of general fund operating expenditures; and debt service as a percentage of key revenues (e.g., property or sales taxes).

3. *What agencies should be surveyed?* In developing the benchmark group, agencies should look for key similarities, such as form of government; population size; demographics (e.g., age and income); geography and weather; economy; community characteristics (e.g., central city, suburban, rural); general fund revenues and expenditures; revenue mix and diversity; and scope of services delivered.

Conducting the Benchmark Analysis. After determining the scope of the assessment, key steps in conducting the analysis include:

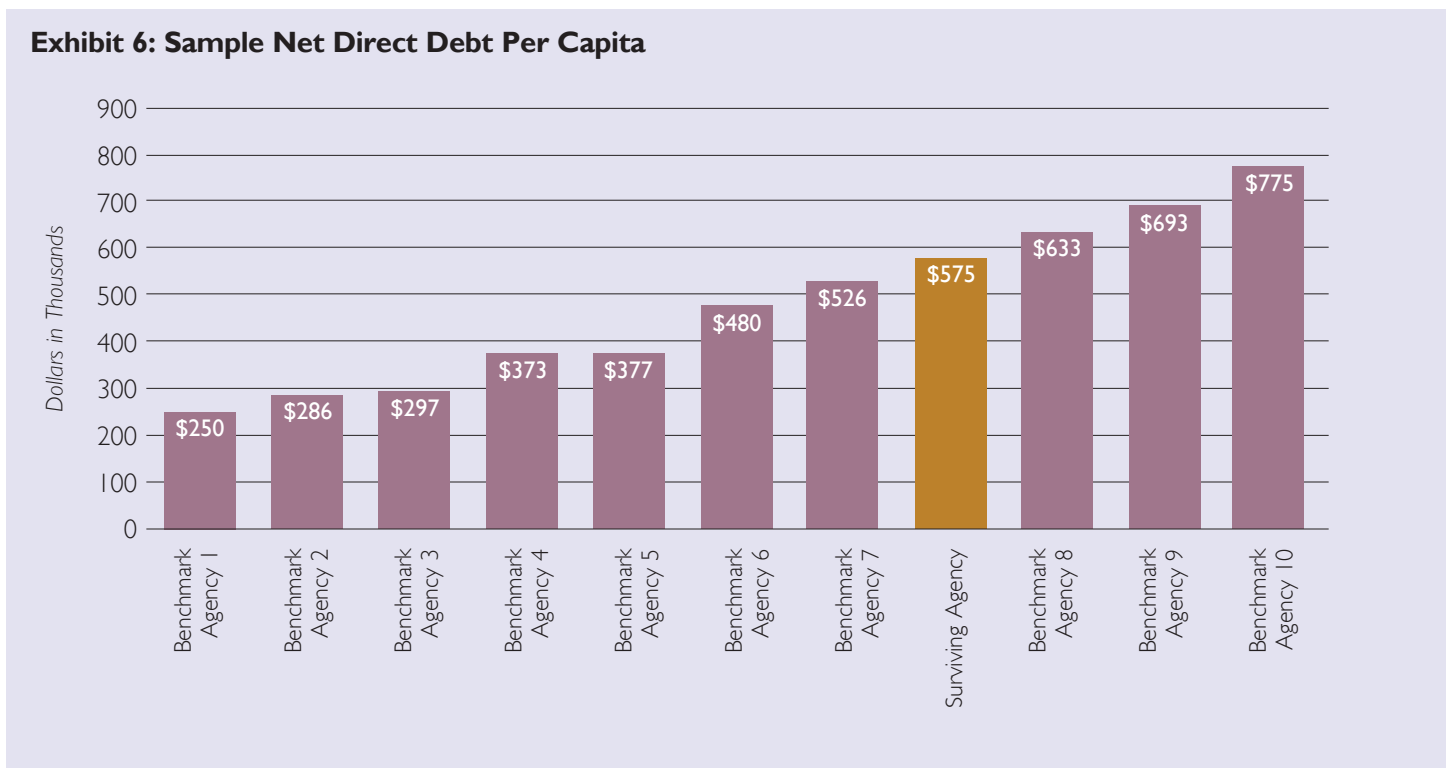


Exhibit 7: Sample Annual Direct Service as Percentage of Operating Revenues



- Reviewing the most recent comprehensive annual financial reports from the benchmark agencies, which are likely to contain most (if not all) of the needed information.
- Developing indicators for the jurisdiction and the benchmark group.
- Calculating group mean and median, based on key indicators.
- Evaluating the position of your agency as compared to the benchmark group median or mean.

Exhibits 6 and 7 provide examples of the resulting benchmark analysis.

Incorporating Findings into Debt Policies. Where should the jurisdiction be, relative to benchmark? For example, in setting maximum debt service as a percentage of general fund revenue (which indicates the extent to which debt service requirements potentially limit budgetary flexibility), the organization might adopt the following policy: Debt service should not exceed 8 percent of general fund revenues.

Benchmark Analysis Caveats. While benchmark analysis may be use-

ful as a starting point, there are several caveats regarding its usefulness. For one thing, the peer group benchmark results are static, while the values and fiscal situation of the agency under analysis are not. This can be addressed by frequently updating the peer group analysis, which means the benchmark analysis should be updated annually, or at least each time the jurisdiction goes to market. Of course, ongoing analysis is time-consuming and cumbersome, and most peers are unique in some way (e.g., police, parks, fire, libraries, or utilities either being not provided at all or provided in a significantly different way or level). Lastly, how much do you want the policies or practices of others driving your financial future? Being informed by what others are doing is useful, but organizations should avoid being driven by it.

Communities need the fiscal capacity to link their goals with the resources needed to achieve them. And this is rarely a matter of luck.

Credit Rating Agency Guidelines.

Along with benchmarking the jurisdiction against other agencies, the rules of thumb used by credit rating agencies can also be a helpful starting point in preparing debt management policies. In general, credit ratings will be adversely affected when the ratio of net direct debt to property market value exceeds

6 percent; debt retirement is less than 25 percent in five years and/or 50 percent in ten years; net direct debt per capita exceeds \$2,500; or a city or county's ratio of debt service to general fund revenues exceeds 10 percent.

ONE CITY'S APPROACH

The debt management policies the City of San Luis Obispo has adopted, along with other key financial management practices, have played a key role in preserving the city's long-term fiscal health while at the same time enabling the construction of high-priority facility and infrastructure improvements.

Organization, Adoption, and Ongoing Review. The city's capital financing and debt management policies are included in the city's two-year financial plan and budget. The council formally approves this broad range of budget and fiscal policies and comprehensively reviews them at least every two years as part of the budget process, and on an ongoing basis as needed.

Capital Financing. The city has a clear bias toward pay-as-you-go financing. It only considers debt financing when it is a high priority, one-time project, the useful life exceeds the financing term, or resources to cover debt service. Debt financing is not used for recurring purposes or ongoing maintenance and operations. This includes infrastructure and facility maintenance projects, with the exception of short-term debt for cash flow such as tax and revenue anticipation notes.

Funding Sources. Whenever specific beneficiaries can be identified, this should be the city's first source of funding (along with grants). These include service fees, enterprise funds, assessments, developer agreements, and development impact fees. General purpose debt supported by general fund revenues is the last resort.

Pay-As-You-Go versus Debt Financing. The city uses the several criteria in considering the use of debt financing, on a case-by-case basis. Factors favoring pay-as-you-go are when current sources are adequate and available, current debt is too high, market conditions are not favorable, or ongoing capital maintenance is needed. Factors that favor debt financing are if long-term revenues are adequate to support debt service costs; the project will support an investment-grade



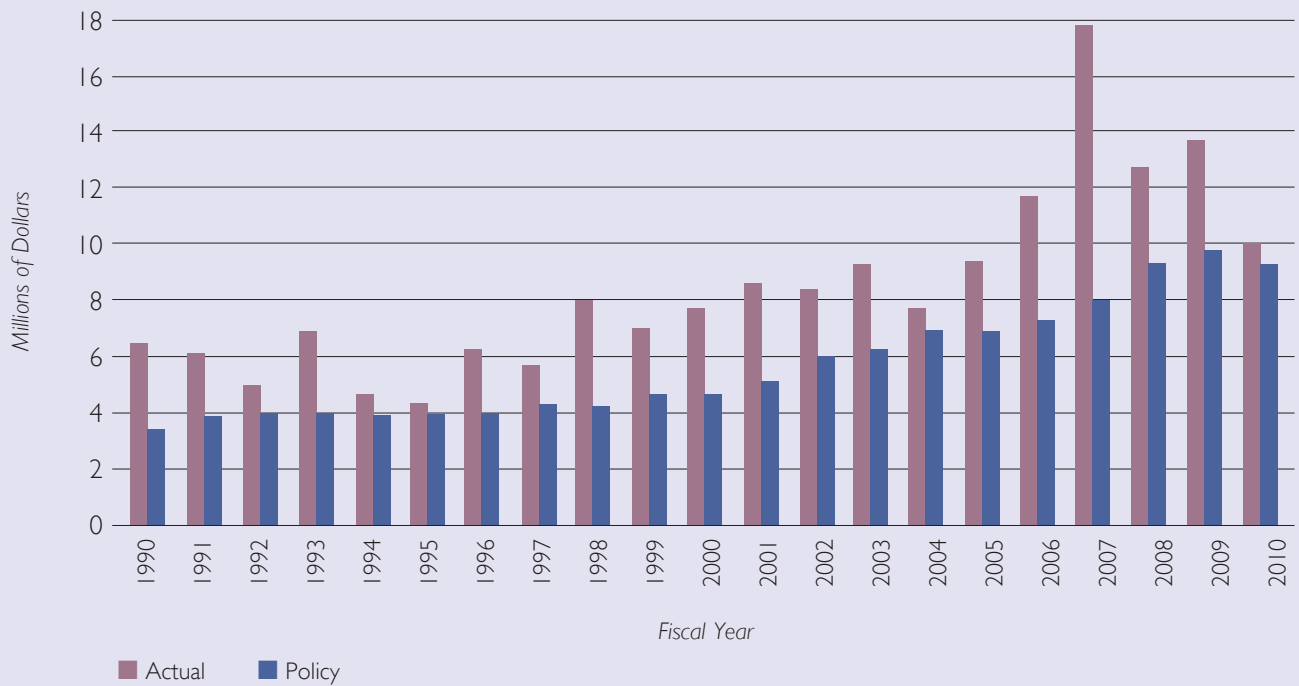
credit rating; there are favorable market conditions; the project is required by federal or state government, and current sources are inadequate; it is a high-priority improvement that is needed immediately to address capacity, and current sources are inadequate; or the life of project or asset is ten years or longer.

Debt Management. The city uses the following guidelines in managing its debt financing:

- Avoid obligating the general fund.
- Prepare an internal feasibility analysis for each issue, considering the impact on current and future budgets and city services.
- Conduct financing on a competitive basis, recognizing that there are situations where a negotiated sale will make more sense.
- Seek investment-grade ratings.
- Review debt as part of the budget process.
- Diligently monitor compliance with covenants and regulations.
- Maintain good ongoing communication with rating agencies.

Refundings. The standard rule of thumb is to achieve present value savings of 3 percent to 5 percent of refunded bond issue. Jurisdictions can do only one advance refunding, so it is important not waste this opportunity for modest savings. Refundings may also provide an opportunity to more favor-

Exhibit 8: San Luis Obispo General Fund Balance (Unreserved, Undesignated): Policy versus Actual



ably restructure debt financing terms and conditions. With this in mind, the city’s policy is generally to consider refundings at 3 percent present value savings or greater. There must be a compelling public purpose for refundings with a present value savings of less than 3 percent. The city moves forward with the refunding if the present value savings is 5 percent or greater.

Debt Capacity. Debt capacity is limited, so jurisdictions need to make it count. Funds borrowed for a project today can’t be used for other projects tomorrow, and funds committed for debt repayment today can’t be used to fund services tomorrow. Long-term capital planning is the key to managing debt capacity. For the general fund, the city uses the following factors in considering debt capacity:

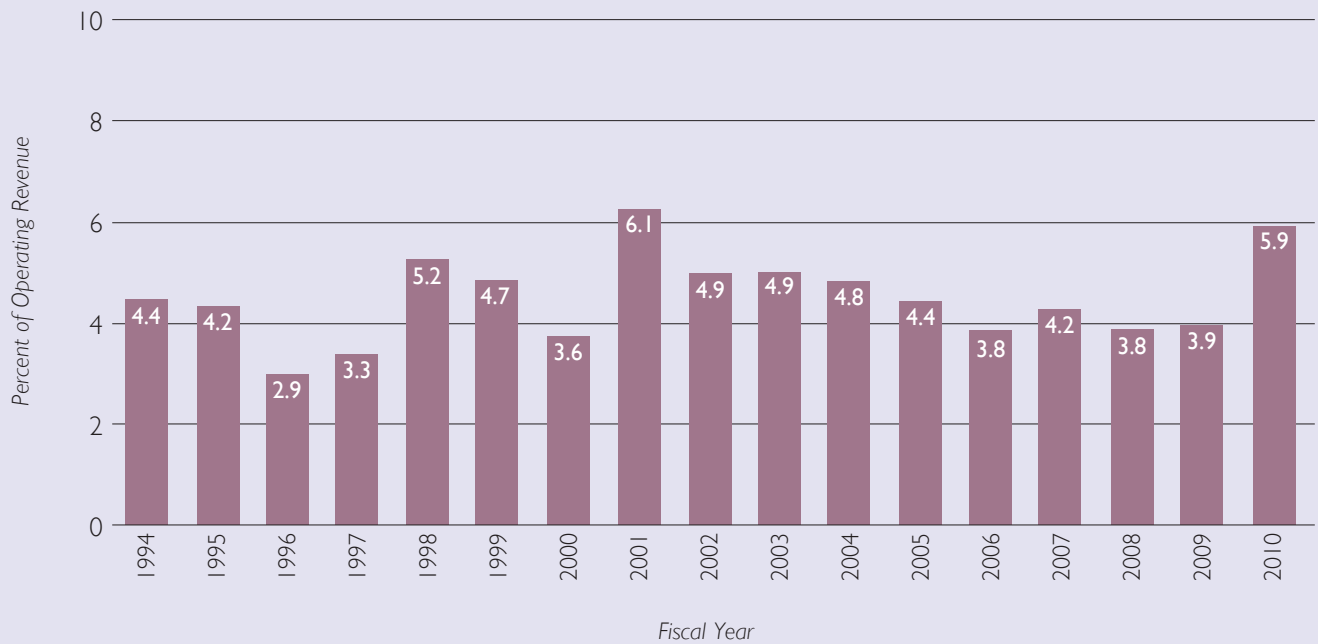
- Annual debt service should generally not exceed 10 percent of operating revenues, and it should never exceed 15 percent.
- Total direct debt should not exceed 2 percent of assessed value.

- No more than 60 percent of the four-year capital improvement plan will be funded from long-term debt.

There are no specific debt limits for the city’s enterprise funds (e.g., water, sewer, parking, transit, and golf), since each operation has different capital needs. For example, the city’s wastewater and parking operations are very capital intensive, so a relatively high ratio of revenues to debt service costs is warranted in these cases. Accordingly, the city’s policy is to set rates as needed to fully cover the cost of operations, maintenance, capital improvements, administration (including indirect costs), and debt service (including any coverage requirements). Under these guidelines, if higher rates will be needed to support a new debt financing, the new rates must be adopted before issuing the debt. Of course, even within this enterprise fund policy, there are real-world constraints that also limit enterprise debt funded by rate increases, not the least of which are community perceptions that water and sewer rates are already too high, or major issues with how rates are structured.

Any debt issuance should be preceded by longer-term financial and capital improvement plans that address fundamental questions.

Exhibit 9: San Luis Obispo General Fund Ratio of Debt Service to Revenues



Does this Work? The acid test of any policy, of course, is whether it achieves its objectives. San Luis Obispo has met or exceeded its minimum general fund balance policy of 20 percent of operating expenditures, net of reserves and designations, in every year since 1990 (see Exhibit 8). This was the case even in the toughest of years — the recession in 1993-1995 and the Great Recession of 2008-2010.

The city has remained well below its general fund policy guideline of keeping debt service costs at less than 10 percent (see Exhibit 9). Since 1994, general fund debt service costs have averaged 4.4 percent of revenues. And even in 2010, with a dip in general fund revenues caused by the Great Recession and new debt service costs of \$830,000 for the construction of a new dispatch center and radio system improvements, the ratio remained less than 6 percent.

CONCLUSIONS

Clearly articulated fiscal policies are the fundamental foundation for long-

term fiscal health, establishing the underlying basis for case-by-case decision making. In providing the context for making decisions, they are helpful guides, not a straightjacket. They are an essential component for any long-term forecasts or contingency plans. And most importantly, they help frame and articulate the jurisdiction's values before they come under stress, which will make doing the right thing easier when tough decisions have to be made. ■

BILL STATLER is the former director of finance and information technology for the City of San Luis Obispo, California (recently named the "happiest place in America" by Dan Buettner, an Emmy winning documentary producer and author of *Thrive: Finding Happiness the Blue Zones Way*). After 35 years in public service, Statler's "next act" is consulting and training. He is also co-author of an upcoming book on local government finance in California that is scheduled for publication in fall 2011.

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