Final

Revision of Rockville's Numeric Debt Management Policies

This memorandum reviews four current numeric Debt Management Guidelines used by Rockville. They give guidelines with which to judge the City's debt. These Debt Management Policies were adopted in 1989 and have not been adjusted since. All four numeric debt management measures were reviewed for continued suitability. The authors are some members of the former Finance and Budget Task Force.

This topic is germane to Rockville's ongoing budgeting process. Borrowing has been one of Rockville's methods to fund Capital Improvements. There is valid concern over what a good level of debt should be for Rockville. As Rockville faces difficulties in funding essential Capital Improvements Program (CIP), Mayor and Council should have up-to-date Debt Management Policies.

In conducting its exhaustive research, the Task Force members reviewed the rating policies issues by the three bond-rating agencies (Moody's, Standard and Poor's, and Fitch). These policies are available on the web. The members also reviewed the national Consumer Price Index increase since 1989 as well as 2 Baltimore-based construction cost indices. Finally, Task Force members spoke to 3 individuals who participated in the adoption of these Debt Management Policies. They are former Mayor Jim Coyle, former Councilmember Jim Marrinan, and former City Manager Bruce Romer. Jim Coyle was a member of the Finance and Budget Task Force and participated in this review of Debt Management Policies.

Rationale for Debt Limit Measures

Debt limit measures give Mayor and Council, City Staff, and residents a way to systematically assess the level of the City's debt. The total dollar amount of debt is, by itself, a poor measure since it says nothing about the City's capacity to pay.

Good measures of debt compare the amount of debt to other numbers such as value of assets, the size of the population, revenue, and pay-down rate. A good measure, therefore, always compares two numbers. There are several numbers that can be used to form measures to judge the amount of debt. The text below indicates which possible debt measures are best for Rockville.

No one measure can portray Rockville's overall debt posture. Therefore it is suitable to use several measures, but just the ones that best apply to this City.

Current Numeric Debt Limit Measures

These limits apply to direct taxpayer supported debt. City debt that is issued for self-supporting Enterprise Funds such as the Water Fund, Storm Water Management Fund, or Sewer Fund, is not part of this discussion. Parking Fund debt is a special case since it is directly supported by the General Fund.

The City's 17 Debt Management Policies are found on page 2-9 of the proposed FY 2013 budget book. This discussion starts with current policies 12, 13, 14, and 15 which give numeric limits. These are:

12. **Neither Maryland State law nor the City Charter mandates a limit on municipal debt.** However, the City will strive to maintain its net tax-supported debt at a level not to exceed 1.0 percent of the assessed valuation of taxable property within the City.

13. The City will strive to ensure that its net tax-supported debt per capita does not exceed $700.

14. The City will strive to ensure that its net tax-supported debt per capita as a percentage of Federal adjusted gross income does not exceed 2.5 percent.

15. Required annual tax-supported debt service expenditures should be kept at or below 15 percent of the City's annual adopted General Fund expenditures. This ratio reflects the City's budgetary flexibility to respond to changes in economic conditions.

The current levels of these measures are shown below in Table 1.

Table 1: Comparison of Current Debt Burden Measures

Page 3-37 (Table 3-79) of the FY2013 proposed budget summarizes these measures:

Current Debt Burden Measure		FY 2013	FY 2014	FY 2015	FY 2016	FY 2017
#12: Debt per Assessed Value (1.0% target)		0.6%	0.6%	0.6%	0.5%	0.5%
#13: Debt per Capita ($700 target)	**With parking**	$1,194	$1,118	$1,043	$959	$876
	Without parking	$653	$630	$535	$507	$412
#14: Debt per Capita as a % of per Capita income (2.5% target)		2.4%	2.2%	2.1%	1.9%	1.7%
#15: Debt Service as % of Operating Budget (15.0% target)		11.7%	11.0%	10.5%	9.9%	9.5%

The third row of Table 1 excludes debt from the Town Center parking garages from other tax-supported debt because the City realizes some revenue from the garages and not all of this particular debt issue is paid for through General Fund revenues. The measures in the third row are a subset of those in row 2.

Rockville does well by these measures except for row 2, policy number 13 which is a static measure. Concern over the use of such a static measure was the impetus for this research.

The figures given in FY 2013 through FY 2017 are based on the assumptions used in the FY 2013 Proposed Operating Budget book. These figures can change depending on decisions made by Mayor and Council, the outcome of the cost of litigation over the parking garages, and other external factors.

Recommendations

There are four recommendations.

1. The limits for current policies 12, 14, and 15 should remain the same (stated in Table 1, column 1).

2. Policy 13 should be updated as follows:

- The $700 per capita limit should be raised to $1200, and this limit should apply to Parking Fund debt as well as General Fund supported debt.
- The per capita dollar limit should be adjusted automatically and annually in accordance with the increase or decrease in the National Consumer Price Index.

The per capita debt limit should be raised to $1200 now to account for the cost of living and cost of construction increases of about 80% since 1989 when the numeric limit was set (Appendix A). Automatic updates will prevent this measure from becoming out of date. The other three measures (12, 14, and 15) are self-adjusting. A measure loses credibility when it becomes badly out of date and gives a misleading picture of the City's debt profile. Additionally, if the City were to abide by an out-of-date limit, it might prohibit borrowing where borrowing would be advantageous to taxpayers and easily financed without negatively impacting the City's Triple A bond rating.

3. The debt limits apply to all direct taxpayer supported debt, including the part of the Parking Fund debt supported by the General Fund. However, the per-capita measures should be stated twice, once including the Parking Fund debt and once excluding it as shown in Table1 above.

This separation of the parking garage debt serves as a reminder that (1) this is a case where the General Fund must directly support an Enterprise Fund, and (2) the Parking Fund obligations may greatly increase due to litigation costs and possible adverse outcomes as well as eventual elimination of parking reserve contributions to the parking debt payments.

4. One additional numeric measure should be considered.

> The City will strive to ensure that its amortization rate shall be at least 25% in 5 years and 50% in 10 years. The City is currently at 26% and 55% respectively and meets these criteria.

This measure is recommended by all 3 rating agencies and gives a quite different view on debt levels compared to the other measures.

Historical Perspective

Coyle, Marrinan, and Romer indicated that in the late 1980s the City wanted to adopt Debt Management Policies as part of an ongoing effort to well manage the City's budget. Under the direction of Mayor and Council, Romer and his staff conducted the research. In addition, Romer had contacts with the bond rating agencies from his stint as City Manager in Iowa. The policies were adopted through these efforts. In follow-up conversations with these individuals, all three noted that the 1989 limit of $700 per capita was not meant to hold indefinitely into the future and not be adjusted for inflation.

Finance and Budget Task Force Report

The Finance and Budget Task Force report, issued September 20, 2010, did not directly address the 4 Rockville Debt Management measures. The Task Force simply did not have sufficient time and information to develop recommendations on the subject. Its report indirectly addressed the issue by proposing that the goal of maintaining a Triple-A bond rating be added to the City's Financial Management Policies. Debt management policy 1 was added by Mayor and Council in 2011 at the suggestion of the Task Force.

> 1. Debt management will provide for the protection and maintenance of the City's AAA/Aaa bond rating, the maintenance of adequate debt service reserves, compliance with debt covenant provisions and appropriate disclosure to investors, underwriters and rating agencies.

A Triple-A bond rating implies that the City manages its debt conservatively and responsibly. However, this standard does not specify criteria that the Mayor and Council can use to guide its decisions about debt financing. In that regard, the four current policies fill that gap and the additional recommended criterions further strengthens Mayor and Council and City Staff ability to judge levels of debt.

Appendix A: Review of Cost of Living Increases since 1989

Three cost indices show an approximate 80% increase in costs from 1989 to 2011. The three measures include the National Consumer Price Index and the BCI and CCI construction indices from Baltimore as reported by the Engineering News Record (Rockville has a subscription to this service which allows it to access and use these proprietary data). The BCI and CCI indices are similar, but have different ways of incorporating the cost of union labor.

Table 2: Comparison of Debt Burden Measures

Index	CPI-National	BCI-Baltimore	CCI-Baltimore
1989 index	126.1	2432.2	3707.2
2011 index	225.7	4483.7	6527.1
Percent change	79.0%	84.3%	76.1%

Appendix B: Overview of Rating Agencies' Criteria

Debt is only one factor considered by the credit rating agencies when they evaluate the credit quality of bonds issued by state and local governments. As you might expect, the rating agencies ask a number of questions that are similar to what a bank asks when it considers a mortgage application from a prospective homeowner. In addition to (1) the amount of debt outstanding, the rating agencies assess (2) the future income available to meet current obligations and to repay debt, (3) the stability of that income, (4) the borrower's ability to budget for known and potential expenses, and (5) the borrower's ability to manage its finances. Interestingly, the last 4 factors far outweigh debt profile in each of the rating agency's assessment.

By way of example, Moody's states that debt profile carries the lowest weight (10%) of the four factors it considers, as shown in the table below.[1] The other two rating agencies use similar criteria to analyze local government's credit strength.[2]

Table 3: Moody's Rating Factors

Economic Strength	40%
Financial Strength	30%
Management and Governance	20%
Debt Profile	10%

The following paragraphs explain these Moody's Rating Factors.

Economic strength measures the ability of the local economy to generate stable and predictable revenue sufficient to meet operational and debt service needs. The principal sources of revenue for Rockville's general fund are property taxes and, to a lesser extent, income taxes. The rating agencies assess the size, growth, volatility, and diversity of the tax base. Mayor and Council have limited short-term ability to directly influence these factors, although their decisions about future development, investment in infrastructure, zoning decisions, regulatory environment, and tax policies can affect long-term economic development.

Mayor and Council have much greater ability to influence the remaining three factors, which together make up 60% of Moody's overall assessment. Rockville's Triple-A rating suggests that Rockville's Mayor and Council and City Staff have consistently over a long period managed the City's finances extremely effectively.

Financial strength measures the ability of the local government to weather budgetary pressures. This includes an assessment of the general fund reserve in comparison to operating revenues (or operating expenditures), the composition of assets and liabilities, liquidity of reserves, operating flexibility (on both the tax and expenditure sides of the budget), and operating trend.

Management and governance assesses the ability of the local government to implement budgetary and financial strategies that maintain credit strength over the long-term and over the business-cycle. Moody's looks at the actual performance of the budget compared to projections, the local government's ability to control expenditures, adoption and adherence to fund balance policies, the extent to which the local government develops and uses multi-year fiscal plans, and full and timely disclosure of budgetary and financial information. Management of debt and capital planning are also critical elements, as are the performance of the local government within its statutory and regulatory environment as compared to other local governments subject to the same constraints.

[1] "General Obligation Bonds Issued by U.S. Local Governments," Moody's Investors Service, October 2009, page 5.
[2] S&P, for example, cites five general criteria: government framework, financial management, economy, budgetary performance, and debt and liability profile. See "U. S. Public Finance: U. S. Ratings Methodology," Standard and Poor's Ratings Services, January 3, 2011, page 1.

Debt profile looks at the amount of debt that is supported by the local economy, the ability of the local economy to repay additional debt, the amount of potential future borrowing needs, the impact of debt on financial flexibility, and the extent the government can conservatively structure debt repayment.

Possible Debt Burden Measures

Table 4 summarizes debt burden measures employed by the major credit rating agencies.

Table 4: Possible Debt Burden Measures

Measure	Moody's	S&P	Fitch	Rockville
				Current
Tax-supported debt per capita		X	X	#13
Tax-supported debt as a % of personal income		X		#14
Net direct debt as a % of market value of tax base	X		X	
Overall net debt as a % of tax base	X		X	#12
Amortization rate (e.g., 50% of debt repaid within 10 years)	X	X	X	Proposed
Debt service as a % of total operating expenditures	X	X	X	#15
Pension funding ratio	X	X		
Pension funding levels	X	X		

Credit ratings generally assess both debt issued by the local government (e.g., debt issued by Rockville) and debt incurred by overlapping entities (e.g., combined debt issued by Rockville and Montgomery County). Debt is defined broadly to include bonds supported by dedicated revenues, capital leases, lease revenue debt, and other fixed obligations, such as pension obligations. General obligation debt that is supported by enterprise revenues is frequently excluded if the enterprise fund is self-supporting.

Recommended Debt Burden Measures and Goals

Table 5 below summarizes this report's recommendations. Rows A and C relate to revenue. Since the City's main source of general fund revenue is property taxes, we recommend the measure in row A that compares debt to the total market value of the property tax base.[3] Tax-supported debt as a % of personal income (row C) relates debt to the income of residents who will be taxed to repay that debt. We do not recommend limits related to Rockville's pension fund liability. Rows B, D, and E give a variety of perspectives on debt burden.

We recommend setting moderate goals as stated by the credit rating agencies. A moderate goal may be reasonable for a temporary period of time, when a sound plan is in place to move back toward the low end over the longer term.

[3] These measures of debt would exclude enterprise fund debt under either of two circumstances: (1) the enterprise fund has been self-sustaining for the past 3 years, or (2) the enterprise fund operates in a non-competitive environment and a financial plan has been adopted that will return the Enterprise Fund to self-sustaining status within 3 years.

Table 5: Comparison of Debt Burden for Recommended Measures

Recommended Measure	Agency levels			Rockville FY 13 status	Proposed Goal
	Low	Moderate	Agency		
A. Overall net debt as a % of tax base (Rockville's current #12)	< 2%	< 5%	Fitch	0.6%	< 2%
B. Tax-supported debt per capita (with Parking) (Rockville's current #13, revised)	< $500	< $2,000	S&P	$1194	< $1200
B. Tax-supported debt per capita (without Parking) (Rockville's current #13, revised)				$653	< $700
C. Tax-supported debt as a % of personal income (Rockville's current #14)	< 2%	< 4%	S&P	2.4%	< 2.5%
D. Debt service as a % of total operating expenditures (Rockville's current #15)	< 2%	< 6%	S&P	11.7%	< 15%
E. Amortization rate (proposed)	35% within 5 years	25% within 5 years	Fitch S&P	26%	> 25%
	65% within 10 years	50% within 10 years		55%	> 50%

Note: While the goal of measure D is higher than the *Moderate* level, Rockville's Finance Department, indicates that the agencies find the level of 15% s acceptable for Rockville. This is a long-standing goal.

Thanks

We express many thanks to the members of the 2010 Finance and Budget Task Force who contributed to this memorandum. Thanks are also due to the City's Finance Department for a technical review. A debt of gratitude is due to Jim Coyle, Bruce Romer, and Jim Marrinan who are among those who first implemented these policies 1989 and who contributed to our understanding of these policies.