Madison

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To: Mayor Soglin
Council President Bidar-Sielaff
Alders

From: David Schmiedicke
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Subject: Discussion of Bond Premiums, Application of General Debt Reserves, and Use of Non-Recurring Revenues

One of the items on the December 11, 2012, Council agenda is consideration of a proposed ordinance that would require that any amount of general debt reserves applied to reduce debt service in the city's annual budget be matched by at least an equal appropriation from the general fund for capital projects. The goal of this ordinance, as stated by Mayor Soglin, is to ensure that the levy capacity created through use of debt reserves to pay debt service is used for one-time capital expenditures, thereby potentially reducing use of general obligation borrowing and limiting structural imbalances in future budgets.

In order to assist the Council in its consideration of this item, this memo provides background on the Debt Service Fund, including deposit of debt reoffering premiums ("premiums") and application of general debt reserves to pay debt service, the structural balance of the city general fund budget since 2011, and policies for use of one-time revenues developed by other communities.

<u>Debt Service Fund</u>

The Debt Service Fund (DSF) receives revenues from other city funds in support of repayment of city debt. Unused proceeds from borrowing due to under-spending in capital projects along with premiums and interest earnings are also deposited in this fund. Revenues deposited in the DSF can only be used to pay debt service.

<u>Reoffering Premiums</u>

In recent years, bids from purchasers of city debt have been structured with premiums in response to current economic and municipal bond market conditions. The final purchasers of the city's debt are willing to pay an upfront premium in order to receive higher interest payments from the city in future years. The higher interest payments combined with a reoffering premium are more attractive to investors than lower interest rates included in a par bid (i.e., a bid without a premium) because it helps investors hedge the risk of carrying a low interest rate investment if interest rates rise in the future.

For example, the city sought bids on $39.655 million of general obligation borrowing in September 2012. The winning bid (with a true interest cost of 1.52%) included a $4.451 million reoffering premium. The average interest rate associated with annual repayment of the debt is 3.63%. The combination of the $4.451 million upfront premium payment and the interest rate on annual repayment results in the true interest cost of 1.52%. Another way to view the premium is that the city received $44 million from investors in return for $39.7 million of principal repayments, plus interest.

Under Chapter 67, Wisconsin Statutes, premiums are deposited in the city's Debt Service Fund and can only be used for debt service. Generally, under federal tax law, borrowing proceeds must be used within 24 months. Over the past few years, reoffering premiums on the city's GO note sales have varied from $293,000 in 2006 to $10 million in 2011.

General Debt Reserves

Revenues deposited to the DSF over and above debt repayment schedules (e.g., related to bond premiums) create a surplus or reserve available to pay additional amounts of debt service. Allocation of surplus proceeds from the DSF to pay debt service has varied from $2 million to $11 million between 2006 to 2012 (the difference between the amount of premium deposited and total surplus funds reflects unused proceeds from GO borrowing in past years associated with projects that came in under budget). Payment of debt service from surplus proceeds (i.e., application of General Debt Reserves) in the Debt Service Fund reduces the amount of levy needed for that purpose in that year only (i.e., it is a one-time effect unless the reserve is replenished in the subsequent year due to bond premiums received on debt issued in that year or due to under-spending in capital projects supported with debt and any interest earned).

Direct Appropriation to Capital

Funding has been appropriated on a one-time basis in operating budgets to fund capital projects. Prior to 2012, approximately $500,000 was appropriated in the 2008 and 2011 budgets. Appropriations for capital projects can reduce future year debt issuance as well as offset the one-time effect of applying General Debt Reserves to reduce debt service.

The table below shows the amounts of premium, General Debt Reserves and Direct Appropriation to Capital since 2006:

Borrowing Year	Budget Year	Premium Allocated to Debt Service Fund	General Debt Reserves Applied to Offset Debt Service Payments in Budget	Direct Appropriation from the General Fund to Capital in Budget
2012	2013	$ 5,184,769	$ 5,042,507	$ 4,876,996
2011	2012	$ 10,130,832	$ 11,200,000	$ 6,952,000
2010	2011	$ 3,944,232	$ 3,518,664	$ 507,248
2009	2010	$ 1,753,542	$ 4,063,997	$ -
2008	2009	$ 875,162	$ 2,486,007	
2007	2008	$ 757,427	$ 3,000,000	$ 565,385
2006	2007	$ 293,139	$ 2,221,000	$ -

Structural Balance of City General Fund Budget

Each year, the City must adopt a balanced budget. A budget is balanced if revenues expected to be collected in that year, along with application of any reserves (surpluses), is equal to anticipated expenditures (as approved in appropriations).

A budget is considered to be "structurally balanced" if on-going revenues are equal to or greater than on-going expenditures. Best practices in governmental budgeting attempt to avoid reliance on one-time revenues for on-going expenditures. Such a situation, known as a "structural deficit", can result in budgetary challenges in the event the one-time revenues are no longer available.

The table below shows the structural balance of the general fund since 2011. Revenues have been adjusted to remove non-recurring items, including the variation in revenues due to the two-year license cycle for certain licenses, and fund balances. The Premium Stabilization Fund Balance is considered on-going for purposes of this analysis since sufficient funds are expected to be available through 2014. Expenditures are also adjusted to reflect one-time amounts, including direct appropriations to capital projects and application of General Debt Reserves to reduce debt service. The table shows a structural deficit of $3 million in 2011, $4 million in 2012 and $1.1 million in 2013. These amounts increase if the expected change in debt service due to borrowing authorized in the capital budget for that year is included.

Structural Balance			
($ in millions)	**Adopted Budget**		
REVENUES	2011	2012	2013
General Fund Revenues	$ 68.76	$ 64.05	$ 70.52
Fund Balance Applied	-	-	1.160
Premium Stabilization Fund Balance Applied	-	2.022	2.041
Property Tax Levy	179.491	186.737	193.400
Total Revenues	$ 248.25	$ 252.81	$ 267.12
less Two-Year License Revenue	-	(0.100)	-
less Fund Balance Applied	-	-	(1.160)
On-going Revenues	**$ 248.25**	**$ 252.71**	**$ 265.96**
EXPENDITURES (General Fund and Net Library Fund)			
Operating Expenditures	$ 216.48	$ 217.42	$ 225.22
(excluding Debt Service and Direct Appropriation to Capital)			
Debt Service (excluding General Debt Reserves)	34.781	39.633	42.065
General Debt Reserves Applied (to reduce general fund debt service)	(3.519)	(11.200)	(5.043)
Direct Appropriation to Capital	0.507	6.952	4.877
Total Expenditures	$ 248.25	$ 252.81	$ 267.12
less General Debt Reserves	3.519	11.200	5.043
less one-time Police Academy Acceleration	-	-	(0.257)
less one-time Elections Costs	-	(0.341)	-
less Direct Appropriation to Capital	(0.507)	(6.952)	(4.877)
On-Going Expenditures	**$ 251.26**	**$ 256.71**	**$ 267.03**
Annual Balance	-	-	-
Structural Balance	**$ (3.01)**	**$ (4.01)**	**$ (1.07)**
(On-Going Revenues less On-Going Expenditures)			
Structural Balance with Following Year Debt Service	**$ (7.86)**	**$ (6.44)**	**$ (5.59)**

A structural deficit is the first draw on revenue growth in the subsequent year in the event that any non-recurring revenue sources are no longer available. Debt service in the subsequent year should be considered in the structural balance analysis since the adopted capital budget authorizes expenditures that will ultimately be funded from issuance of debt. The structural balance with following year debt service amounts in 2013 represent 2.9% of the 2013 property tax levy (i.e., the property tax levy in 2014 will have to increase by 2.9% to meet the structural gap). None of these estimates takes into account growth in spending due to cost increases, including wage increases, fringe benefit costs, fuel expenses, and program changes.

Maintaining reserves is also a best practice in government budgeting. Reserves allow governments to ameliorate short-term revenue shortfalls (due to economic conditions), avoid short-term borrowing for cash flow purposes, meet emergency situations, and address other year-to-year variations. The level of reserves varies by community. Madison has a general fund unassigned balance goal of 15% of subsequent year general fund expenditures. At the end of 2011, unassigned fund balance represented 16.6% of general fund expenditures for the subsequent year. Moody's rating agency cites the city's healthy General Fund reserve levels as one of its strengths that justifies the city receiving its highest bond rating on general obligation debt.

Many communities have also established policies for use of reserves. Below is an excerpt from the policy adopted by Alexandria, VA. Like Madison, Alexandria has the highest possible rating on its debt.

> The use of fund balances to meet recurring operating budget needs is generally frowned upon by financial experts and bond rating agencies because it leads to unsustainable levels of spending in the future as the expenses recur but the fund balances are depleted. There are several situations in which the use of fund balances may be appropriate:
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> 1. Generally the use of fund balances for non-recurring expenses, such as capital projects, or planned transitions to other funding sources (such as the City's current plans to fund Other Post Employment Benefits (OPEB)) can be viewed as prudent.
> 2. The use of small surpluses from the immediate past fiscal year – particularly if a much larger part of the surplus is designated as a reserve for possible one-time expenses or added to the unreserved or undesignated fund balance – is an acceptable practice, especially if the size of such budgeted use of surpluses for recurring operating expenses is held steady or is declining from the previous year.
> 3. The use of significant fund balances to meet recurring operating expenses should be confined to an unplanned emergency situation – such as a sudden and precipitous and unbudgeted decline in revenue for which no reasonable expenditure reductions or tax rate increases can be planned and implemented in a timely fashion. The City's undesignated/unreserved fund balance is meant for catastrophic events, and not general downturns where there are expenditure reduction or tax increase options. In effect, the City's unassigned fund balance would be used to respond to "hurricanes" and not "rainy days".

4. The use of these fund balances should be a temporary measure and efforts should be made to restore the fund balance ratios to the levels called for in the City's financial policies through future budget surpluses.

No examples of these policies being adopted in ordinance have been found. However, some states have either statutory or constitutional requirements to establish reserves by limiting expenditures to some percentage of revenues, or other means. For example, under Wisconsin state law, 50% of actual revenues collected by the state in excess of budgeted amounts must be placed in the state's Budget Stabilization Fund.

Madison has been very prudent in the use of reserves to fund the operating budget, with no more than 3% of general fund expenditures in any one year since 1990 supported by the application of funding from reserves. The city has been able to build its reserve levels to reach its policy target of 15% over the last several years. Growth in balances beyond targets should generate further policy discussion regarding allocation of revenues to reserves rather than to other program priorities.

Conclusion

General Debt Reserves, often resulting from deposit of bond premiums in the Debt Service Fund, must be used to pay debt service, which in turn reduces the amount of property tax levy needed for debt service. That levy capacity can be used for other purposes. However, that levy capacity may be needed to pay debt service in the subsequent year to the extent that General Debt Reserves are depleted (e.g., a lower amount of premium is received in the subsequent year). In other words, the ability to use General Debt Reserves may be non-recurring, or reduced, in future years and impact the year-to-year increase in debt service costs. The levy might have to increase more than usual, or growth in other expenditures reduced to balance the budget. Incorporating non-recurring expenditures into the budget (e.g., for capital projects) is one way to smooth the impact of the premium on debt service costs and the overall budget.

Revenue constraints associated with state-mandated levy limits and capacity of the tax base, along with expanding infrastructure needs and growth in health care and pension costs, will require that the Mayor and Council continue to carefully weigh priorities and seek cost-effective ways to deliver services. Overreliance on non-recurring revenues for on-going costs can result in the need to consider relatively large permanent spending reductions or revenue increases in future years.