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TENNESSEE

MEMORANDUM

December 11, 2012

TO: Board of Mayor and Aldermen

FROM: Eric S. Stuckey, City Administrator
Russ Truell, Assistant City Administrator

SUBJECT: Update on Debt Capacity Model

Purpose

The purpose of this item is to provide background on the changes in the debt capacity model since the last review on April 18, 2012.

Background

The debt capacity model, which is prepared for the City by our independent financial advisor Public Financial Management (PFM), attempts to provide an indication of financial capacity in future years to adequately handle obligations resulting from current decisions about capital projects. It does so by making calculations about the level of debt service and converting those numbers into ratios that are customarily used by rating agencies and municipal bond investors. To look at overall financial health, several ratios are monitored, in much the same way that a doctor uses blood pressure, temperature, height/weight ratios, blood work, etc., to gain a sense of a patient's overall condition.

In April of this year, staff recommended several scenarios which would move forward some of the Board's priority projects without adding bonded debt that would exceed the future debt amount assumed to be viable by the PFM capacity model. All of the projects were approved with the exception of Carothers Parkway South, on which additional design work was ordered to determine how the phasing (or lack of phasing) of Carothers would fare against the capacity model projections.

As the end of the calendar year approaches, we now have actual construction bids available for several of the projects that previously were estimates only. Those bids allow us to make more precise estimates on the awarded projects, as well as those that are still waiting to go through the bidding process.

Additionally, we have audited financial results for the most recent fiscal year, including the reduction of outstanding debt due to another year of scheduled bond repayments. In addition to a $6 million reduction in outstanding principal, during the last twelve months we also refunded a variable-rate bond issue by locking in a low interest rate. Although the interest rate after refunding is slightly higher than the short-term rate that we were paying, the fixed interest rate that we will pay for the duration of the bonds is less than the interest rate assumed in the capacity model for years after 2013. That results in some interest savings in the financial calculations.

Also affecting the model are the actual operating results for FY2012. In the modeling process, it is necessary to assume growth rates for various revenue streams and expense categories. For most revenues like local sales tax, the long-run assumption is essentially the long-term rate of inflation plus

the estimate of population growth. As you know from the recent audit report, our sales and property tax revenue exceeded our expectations. That resulted in an increase in the capacity to support additional debt. Similarly the expenditures in the General Fund were less than our growth estimates predicted, which also increased the capacity. The estimate in the model of a balanced budget, where revenues match expenses, was the appropriate forecast; however, the City ended FY12 with a $1 million surplus, which in turn increased our fund balance and, albeit very slightly, the ability to service debt as calculated by the capacity model.

The project bids also made a difference in the capacity calculations. Although some projects were somewhat higher than anticipated, many of the projects appear to be lower than the initial estimates included in the model calculations. Additionally, the breakdown of some projects will result in a lower demand on General Fund for debt service because of the composition of the work. For instance, the streetscape elements in the Hillsboro Road project are a larger percentage of the project than originally anticipated. Thus, the amount to be paid by the Hotel/Motel Tax Fund will be larger and the draw on General Fund revenues will be lower. The result is that there is a slight tilt upward on the amount of debt that can safely be serviced by General Fund revenues.

Another benefit of the construction bids that have already been received is a reduction in estimated costs for Hillsboro Road. The April version of the capacity model included $11 million in additional debt for the north phase of the Hillsboro Road project (Del Rio to Mack Hatcher). Based on the construction bids for the south phase of Hillsboro, it is now anticipated that the additional debt to be paid from the General Fund will be approximately $2 million less than the amount included in the original capacity calculations in 2009.

All of the items listed above result in small changes to the forecasted numbers in the PFM model. Although individually small, collectively the changes have resulted in improving one of the benchmarks that was of some concern in April. The "Net Direct Debt as a % of Market Value" has changed from a yellow caution light to a green light. Although the "Debt Service as a % of Operating Expenditures" still shows as red, the December report shows four of the five Affordability Matrix measures as positive. Remember that a large part of the reason that the "Debt Service as % of Expense" is red results from the major reduction in our operating budget beginning in 2009. That reduction inflates the ratio. The accuracy of that ratio depends on one's opinion of the level of our current budget relative to the economic and population growth of Franklin and the level of services being provided.

Because the change in the overall numbers are small relative to numbers already included in the capacity model, it is difficult to see a substantial change in the Affordability Matrix that PFM provides on Slide #9 and the graphical presentation on Slide #8. For that reason, we have again included at the bottom of the Slide #7 a couple of spreadsheets that show the numerical impact of adopting Carothers Parkway South scenarios 1, 2, and 3. This gives more detail on the exact amounts needed to fund the projects, as well as the impact on the one ratio that is in the red category. The "Debt Service as a percentage of the General Fund budget," on which we have focused much of our attention during meetings, has been calculated for each of the three phasing options. It should be noted that the difference in the ratio varies (at the uppermost point of impact in 2016) from 11.19% for Scenario 1 to 11.45% for Scenario 2 to

11.72% in Scenario 3. The dollar increase in debt service for all projects would be, respectively, $526,721 versus $607,171 vs. $693,750, or a maximum differential of $167,029 per year.
It should be noted that the numbers provided have been calculated using a number of assumptions about interest rates, the timing of the expenditures, the timing of debt issuance, the amounts issued in each installment, and the growth of general fund budget. For example, at current interest rates the amount required for debt service is roughly $6 per year for each $100 of borrowing. The model assumes $7 per $100. The expenditures are assumed to be made at the beginning of the fiscal year in which the project is budgeted. It is unlikely that the project schedule will hold true to the timing estimates, which gives the model a conservative tilt on the timing of the outlays. Nevertheless, we have assumed that the expenditures are on the front end of the time period.

As a companion to the expenditures, the borrowing for those expenditures in year one are assumed to occur within the same year of the expenditures with the debt service beginning to be paid in the next fiscal year. Thus, borrowing in FY2012 is assumed at mid-year, with principal and interest payments due in full in FY2013. As a matter of procedure, it is unlikely that we would issue debt that quickly. The only reason to do so would be to take advantage of current low interest rates or to optimize the use of issuing debt under the "bank-qualified" rule for small issuers.

One significant assumption is that there will be zero contribution from impact fees in offsetting the principal and interest payments of the borrowed funds. We know that there will be a significant contribution of impact fees from the area surrounding the Carothers Parkway South project, but have not included those as an offset to the cost of the project or a potential source for debt service payments. A report from the Planning Department estimates that roughly half of the funds needed for the project will come from Road Impact fees on developments that are currently in the pipeline.

Even using the very conservative assumptions described above, the ratio of debt service as a percentage of the General Fund budget would move from roughly 9.9% to 11.7% using Scenario 1, the most expensive of the three scenarios provided. In dollars, the additional debt service for all projects would top out at $2.2 million per year and the additional debt, including the portion already approved for Hillsboro, would total $33 million; that compares to our annual reduction (payoff of principal on existing debt) of over $6 million per year.

The PFM presentation is attached.