VGFOA/SPIA
Debt Management Workshop

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1. Choosing Debt Versus Pay-Go

"Pay-as-you-Go"

- Cash Funding of Capital Projects

- Pros:
  - No interest costs
  - No cost to issue debt
  - No burdening of future generations with debt

- Cons:
  - Critical Infrastructure may not be kept up to standard or legal requirements not met
  - Growth or development opportunities may be missed
  - Operations may be pressured by cash diversion to capital

Debt Financing

- Borrowing Money from a Financial Institution or in the Public Markets

- Pros:
  - Accelerates infrastructure development that might otherwise take years to build
  - Allows a government to be proactive in addressing growth and development
  - Introduces intergenerational equity or "pay-as-you-use"; subsequent generations pay for their fair share of the benefit of the infrastructure

- Cons:
  - Creates a fixed obligation which must be repaid, irrespective of economic/financial conditions
  - May bind the borrower to certain covenants on taxes, rates, etc.
  - Added costs in the form of issuance and interest expense.

2. Multi-Year Financial Planning

Multi-Year Financial Planning

- Formalized, Multi-Year Planning for Capital Projects has become an expectation for Rating Agencies, State Sponsored Lending Programs, and other Lending Institutions

- Capital Planning should not be done in a vacuum!
  - Capital planning and debt will link back to all other areas of your local government – not just the capital budget

- Multi-Year Financial Planning should link back to:
  - "Debt Affordability" – impact of debt on cash-flows/the budget
  - "Debt Capacity" – compliance with Adopted Financial Policies and recognized best practice debt management levels

- Other key considerations
  - Level of debt vs. equity over a planning period (typically 5 years with an eye towards a decade)
  - Timing and structure of new debt – not all debt is viewed the same
  - Self supporting debt (i.e. water and sewer utility) has its own separate set of key benchmarks and best practices (coverage ratios, liquidity levels)

3. Can I Afford to Repay the Debt?

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Tax-Supported Debt

- Debt service relative to budget (< 10-12%)
- Principal outstanding relative to repayment source (e.g. debt to assessed value)
- Debt capacity versus debt affordability (e.g. legal limit versus cash flow sufficiency)
- Understanding the tax-equivalent impact
- Don't forget about operating impact

Revenue-Supported Debt

- May requires a feasibility study by an independent consultant
- Size of the customer base supporting the enterprise is important to affordability
- Think about reserves for future maintenance and system repair
- If not entirely self supporting may require additional back-up from tax revenues that act as a "co-signor" on the loan

4. Matching the Project to the Security

- There are multiple ways to provide security to lenders/investors.

- Security may involve a contractual commitment, a pledge of collateral or a promise to pay.

- In our personal lives, we offer various types of security to lenders:
  - Mortgage contract (house as collateral)
  - Car financing (car as collateral)
  - Credit card (generally, an unsecured promise to pay)

- For localities in Virginia, the following security pledges are relevant:
  - General Obligation Bonds (full faith and credit pledge)
  - Lease Revenue Bonds (backed by appropriation and collateral)
  - Revenue Bonds (special taxes, utilities, parking, toll roads, Dillon Rule, etc.)
  - Moral Obligations

General Obligation and Lease Revenue Bonds

Stand-Alone General Obligation Bonds

- Full faith and credit pledge and unlimited taxing power
- Recognized as the highest and best security pledge in the municipal market
- Available to most Cities and Towns up to 10% of the assessed value of real property
- Available to Counties in an unlimited amount, but most are subject to voter referendum
  - Exception: Stand-alone issue for schools through the Virginia Public School Authority (“VPSA”)
- May be used to secure virtually any project, but traditionally reserved for “bricks and mortar” type projects where the entire community benefits and pays

Stand-Alone Lease Revenue Bonds

- Lease payments are usually paid from general tax revenue, subject to annual appropriation
- “Essentiality” of project is key to security pledge
- Typically marginally more expensive than General Obligation debt
- Asset being financed is typically the collateral for the lease, but other assets may be substituted
- Frequently used by Virginia counties for assets that would otherwise require a General Obligation referendum approval
- Also used for assets that may be necessary, but “unpopular” with voters (e.g. school administration building)

Revenue Bonds

Revenue Bonds

- User fees or special taxes are pledged to bond repayment with no recourse to general revenue
- More limited repayment stream than a General Obligation or other general tax-supported security
- Dillon Rule limits what types of revenue may be pledged
- Trust indenture, bond covenants, reserve fund requirements
- Marginally more expensive cost of capital than General Obligation debt depending on rating

Revenue Bonds (continued)

- Typical uses include:
  - Situations where the borrower wants certain groups of users to pay, not the general populous
  - To capture extra-jurisdictional customers not otherwise subject to taxes (e.g. outside-city water customers); and,
  - Cases where having rates and charges driven by legal requirements, rather than be a part of general budget deliberations.
- If revenue stream is still "ramping up" or subject to project completion and future growth, may need a secondary pledge (e.g. General Obligation pledge or Moral Obligation backstop)

Moral Obligation Bonds

- A promise to pay (no collateral)
- Often used to backstop a weaker revenue bond, such as a start-up special tax district, or a utility credit that is reliant on future rate increases
- Mechanics are to replenish a debt service reserve fund if called upon
- Executive required to request appropriation, subject to legislative approval
- Be wary of giving the moral obligation too freely. If a locality does not honor a moral obligation, all of its other forms of credit may be jeopardized.

5. Matching the Funding Provider to the Project/Security

- There are multiple financing vehicles available to Virginia local governments, including:
  - Local, Regional and National Banks;
  - Stand-Alone Public Bond Issues Using the Borrower's Own Credit;
  - State Sponsored Pool Programs such as the Virginia Resources Authority and Virginia Public School Authority (Schools only); and,
  - United States Department of Agriculture ("USDA") Rural Development.
- Each of these financing options has features that make them suitable for a range of project types, security pledges and localities.

Local, Regional and National Banks

Banks

- Tend to prefer General Obligation bonds
- Will fund well-collateralized leases
- Unless the system/project is well-established, it is more difficult to get revenue and moral obligation bonds funded with attractive rates and terms
- Competitive solicitation recommended
  - "When banks compete, you win"
- Flat rate – do not get the benefit of the traditional yield curve
  - Many banks not typically willing to commit to a fixed rate beyond 10-12 years

Banks (continued)

- If less than $10 million, borrower gains the advantage of bank qualification (i.e. possibly lower rate)
- Prepayment provisions are usually more flexible than public markets
- Typically no ratings or public disclosure requirements
- Typically lower issuance costs than public markets

Stand-Alone Public Issue

Stand-Alone Public Issue

- Any of the security types previously discussed may be issued in this manner
- Requires a credit rating in order to achieve affordable market access
- For good credits, cost of capital can be among the lowest
- Generally not the best option for small localities without established credit ratings or for those who are "in the market" rarely
- Cost of issuance is higher, which suggests borrowing amount should be higher (> $5 million)

Stand-Alone Public Issue (continued)

- On-going public disclosure requirements, including Official Statement and ongoing disclosure to public finance community
- Issuer benefits from maximum control over its debt portfolio
- Ability to maximize debt structuring alternatives that does not exist to the same extent with any other vehicle

State Sponsored Pool Programs (VRA, VPSA)

State Sponsored Pool Programs

- State pools have high credit ratings, which benefit participating localities
- Application process – not all security types fit these programs
- VRA Local Government Infrastructure program will take General Obligation pledge, lease revenue pledge or utility revenue pledge (sometimes requires a moral obligation backstop)
  - Less likely to fund raw land or start up economic development projects
- No ongoing public disclosure requirement (handled by VRA)

State Sponsored Pool Programs (continued)

- Ongoing administrative fee
- Pooled issuance allows for economies of scale and may be lower issuance costs than stand-alone
- Fairly flexible financing terms such as 30 year maturity and ability to fund interest during construction

USDA Rural Development

<u>USDA Rural Development</u>

- Primarily water and wastewater utility projects, but also general government
- Most loans secured by General Obligation pledge
- Relatively low interest rates, with tiered pricing based upon local wealth factors
- Up to 40 year terms
- Grant money sometimes available
- Keeps annual payment low, but total interest over the life of the loan is higher

<u>USDA Rural Development</u> (continued)

- Depending upon the project, extensive application and review procedures exist
- Often the longest process of all the financing vehicles mentioned from start of process to completion
- Loans close only after project completion
- Requires interim funding, typically with a bank

6. Who Else Do I Need on My Team?

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Bond Counsel

- Ensures procedures to authorize bond issue are legal, valid and binding
- Provides legal opinion on tax-exempt status of bonds, a necessary step in obtaining the lowest possible interest costs
- Highly specialized field of law that most local government attorneys are not trained or insured to practice
- Reviews financial disclosure documents

Financial Advisor

- Assists with selection of sale method and applications to funding providers
- Prepares all necessary mathematical computations used by Bond Counsel in rendering opinions
- Evaluates debt affordability and structures plan of finance
- Provides credit information to rating agencies and other interested lenders
- Preparation of financial disclosure documents
- Attends governing body meetings to educate elected officials and the public on funding options and plan of finance
- Evaluates existing debt portfolio for refinancing opportunities

Rate Consultant

- Develops life cycle cost analysis of project
- Recommends rates for adoption to cash flow all requirements
- Often an engineering firm
- Works closely with Financial Advisor

7. When Will I Get the Money?

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<table>
<tr><th><u>Weeks</u></th><th><u>Bank Placement</u></th><th>Stand-Alone
<u>Public Issue</u></th><th>State Sponsored
<u>Pool (VRA)</u></th><th>USDA
<u>Rural Development</u></th></tr>
<tr><td>1</td><td>Legal Authorization</td><td>Legal Authorization</td><td>Legal Authorization</td><td>Legal Authorization</td></tr>
<tr><td>2</td><td>Prepare Request for Proposals ("RFP")</td><td rowspan="4">Prepare Disclosure Documentation and Rating Agency Materials; Select Underwriting Firm(s) and/or Method of Sale</td><td rowspan="2">Prepare Application</td><td rowspan="2">Prepare Application</td></tr>
<tr><td>3</td><td>RFP Sent to Banks</td></tr>
<tr><td>4</td><td rowspan="2">Banks Review RFP</td><td>Application Deadline</td><td rowspan="2">Environmental Review</td></tr>
<tr><td>5</td><td rowspan="3">Credit Review</td></tr>
<tr><td>6</td><td>Review Bank Responses</td><td>Rating Agency Meetings</td><td></td></tr>
<tr><td>7</td><td>Award Financing</td><td>Receive Ratings</td><td rowspan="3">Obtain Interim Funding</td></tr>
<tr><td>8</td><td>Close</td><td></td><td></td></tr>
<tr><td>9</td><td></td><td>Sale</td><td></td></tr>
<tr><td>10</td><td></td><td></td><td></td><td></td></tr>
<tr><td>11</td><td></td><td>Close</td><td></td><td></td></tr>
<tr><td>12</td><td></td><td></td><td>Sale</td><td></td></tr>
<tr><td>13</td><td></td><td></td><td></td><td></td></tr>
<tr><td>14</td><td></td><td></td><td>Close</td><td>Loan Approval</td></tr>
<tr><td>15</td><td></td><td></td><td></td><td></td></tr>
<tr><td>16 +</td><td></td><td></td><td></td><td>Close</td></tr>
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Note: The schedules above are illustrative and for general discussion purposes only.

8. Am I Done Yet? No…

- Borrowers are typically required to provide annual disclosure:
  - Banks/Pools – Audits and occasionally budgets
  - USDA – Detailed expenditure reporting during construction, audits and budget thereafter
  - Stand-Alone Public Issue – Provide audits and updates to certain information contained in public disclosure documents and material event notice filings

- Refinancing of debt:
  - Outstanding debt should be reviewed regularly for refinancing opportunities
  - Hundreds of bond issues in Virginia have been refinanced in the past few years as interest rates have declined to historic lows

9. Am I Done Yet? No… (continued)

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- A Financial Advisor is well-equipped to monitor refunding opportunities on your behalf and report such opportunities in a timely manner.

Refunding Candidates

Callable Par Yields August 9, 2007

Series Type	Revenue	Revenue	Revenue	Revenue	Revenue	Revenue	COP	COP
	Lease Revenue	Taxable	Lease Revenue	Lease Revenue	Lease Revenue	Lease Revenue	Special Oblig.	Special Oblig.
	2004A	2003A	2002A - 1	2002A - 2	2002A -1	2002A -2	2002A - Senior	2002A -Junior
	New Money	New Money	New Money	New Money	New Money	New Money	New Money	New Money
	Project A	Project B	Project C	Project C	Project D	Project D	Project E	Project E
Spread	0.100%	1.700%	0.100%	0.100%	0.100%	0.100%	0.150%	0.550%
Eligible	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Maturity	1-Apr	15-Feb	15-Sep	15-Sep	15-Sep	15-Sep	1-Jul	1-Jul
Call Date	04/01/14	02/15/13	09/15/12	09/15/12	09/15/12	09/15/12	01/01/12	01/01/12
Call Premium	0.000%	2.000%	0.000%	0.000%	0.000%	0.000%	1.000%	2.000%
Issue Cost	1.000%	1.000%	1.000%	1.000%	1.000%	1.000%	1.000%	1.000%
Insurer	None	None	None	None	None	None	Asset Guaranty	None

Maturity	Project A Principal	Project A PV Savings	Project B Principal	Project B PV Savings	Project C (2002A - 1) Principal	Project C (2002A - 1) PV Savings	Project C (2002A - 2) Principal	Project C (2002A - 2) PV Savings
	Eligible		Eligible		Eligible		Eligible	
06/30/06								
06/30/07								
06/30/08	1,085,000	-1.600%	435,000	-15.655%	1,000,000	-1.612%	985,000	-1.612%
06/30/09	1,115,000	-1.505%	450,000	-14.148%	2,030,000	-1.514%		
06/30/10	1,170,000	-1.413%	470,000	-12.808%	1,500,000	-1.420%	655,000	-1.420%
06/30/11	1,230,000	-1.324%	495,000	-11.549%	1,710,000	-1.330%	505,000	-1.330%
06/30/12	1,265,000	-1.239%	520,000	-10.367%	2,325,000	-1.243%		
06/30/13	1,330,000	-1.157%	545,000	-9.348%	2,465,000	-1.159%		
06/30/14	1,395,000	-1.079%	570,000	-8.637%	2,595,000	-0.071%		
06/30/15	1,465,000	-0.282%	600,000	-7.838%	2,235,000	0.891%	500,000	0.584%
06/30/16	1,540,000	0.318%	635,000	-8.534%	**2,860,000**	**1.635%**		
06/30/17	1,615,000	-1.323%	670,000	-8.925%	**3,015,000**	**2.254%**		
06/30/18	1,680,000	-1.804%	705,000	-9.551%				
06/30/19	1,745,000	1.012%	745,000	-9.079%				
06/30/20			790,000	-9.621%				
06/30/21			835,000	-10.143%				
06/30/22			885,000	-10.645%				
06/30/23			940,000	-11.061%				
06/30/24								
06/30/25								
06/30/26								
06/30/27								
06/30/28								
06/30/29								
06/30/30								
06/30/31								
06/30/32								
06/30/33								
06/30/34								
06/30/35								
06/30/36								
06/30/37								
06/30/38								
	Eligible		Eligible		Eligible		Eligible	
	Principal	PV Savings	Principal	PV Savings	Principal	PV Savings	Principal	PV Savings
PV > 3.0%	0	0	0	0	0	0	0	0
		0.00000%		0.00000%		0.00000%		0.00000%
PV > 1.5%	0	0	0	0	5,875,000	114,723	0	0
		0.00000%		0.00000%		1.95273%		0.00000%

Maturity	Project D (2002A -1) Principal	Project D (2002A -1) PV Savings	Project D (2002A -2) Principal	Project D (2002A -2) PV Savings	Project E (Senior) Principal	Project E (Senior) PV Savings	Project E (Junior) Principal	Project E (Junior) PV Savings
	Eligible		Eligible		Eligible		Eligible	
06/30/06								
06/30/07								
06/30/08	1,730,000	[illegible]						
06/30/09	1,770,000	-1.514%			190,000	-2.623%	55,000	-5.456%
06/30/10	1,820,000	-1.420%			210,000	-2.479%	60,000	-4.935%
06/30/11	1,870,000	-1.330%			235,000	-2.341%	75,000	-4.437%
06/30/12	[illegible]	-1.243%			260,000	-2.208%	85,000	-3.959%
06/30/13	[illegible]	-1.159%	990,000	-1.159%	290,000	-1.501%	95,000	-2.558%
06/30/14	1,685,000	-0.269%	390,000	-1.461%	325,000	-0.330%	110,000	-0.376%
06/30/15	1,690,000	0.503%	485,000	-1.632%	355,000	0.712%	**125,000**	**1.627%**
06/30/16	2,025,000	1.067%	250,000	-1.777%	395,000	1.490%	**140,000**	**2.955%**
06/30/17	**1,940,000**	**1.513%**	445,000	-1.744%	**430,000**	**2.139%**	**160,000**	**3.962%**
06/30/18					**470,000**	**2.316%**	**175,000**	**4.138%**
06/30/19					**515,000**	**2.461%**	**195,000**	**4.403%**
06/30/20					**560,000**	**2.661%**	**215,000**	**4.848%**
06/30/21					**610,000**	**3.349%**	**240,000**	**5.246%**
06/30/22					**665,000**	**3.327%**	**265,000**	**5.604%**
06/30/23					**720,000**	**3.368%**	**290,000**	**6.004%**
06/30/24					**780,000**	**3.396%**	**315,000**	**6.370%**
06/30/25					**840,000**	**3.412%**	**345,000**	**6.704%**
06/30/26					**910,000**	**3.417%**	**380,000**	**7.010%**
06/30/27					**2,130,000**	**3.412%**	**845,000**	**7.288%**
06/30/28								
06/30/29								
06/30/30								
06/30/31								
06/30/32								
06/30/33								
06/30/34								
06/30/35								
06/30/36								
06/30/37								
06/30/38								
	Eligible		Eligible		Eligible		Eligible	
	Principal	PV Savings	Principal	PV Savings	Principal	PV Savings	Principal	PV Savings
PV > 3.0%	0	0	0	0	6,655,000	225,723	3,425,000	208,854
		0.00000%		0.00000%		3.39178%		6.09792%
PV > 1.5%	1,940,000	29,361	0	0	1,975,000	47,663	265,000	6,170
		1.51344%		0.00000%		2.41330%		2.32830%

Case Study #1: A New City Hall

- A medium size Virginia city wants to build a $30 million replacement of its old City Hall.
- The entire community benefits and pays for this type of a project
- The Seven Questions:
  1. Cash v. Debt?: The size of the project suggests it be substantially debt-funded, with some City equity.
  2. Which Security? As a City, issuing General Obligation Bonds would be the most cost effective.
  3. Which Funding Provider? Likely a Stand-Alone Issue if Credit is Good; VRA would be a good alternative.
  4. Affordability? Determine tax-equivalent pennies required for additional debt service and in which years
  5. The Team? Need Bond Counsel and a Financial Advisor for the Public Sale; Would Benefit from FA with VRA
  6. Timing of Closing? Count on the financing process taking three to four months; adjust construction schedule accordingly
  7. Done Yet? Have Bond Counsel spell out post-sale disclosure responsibilities and make sure your Financial Advisor will monitor this debt for future savings opportunities.

Case Study #2: Acquiring a Small Water System Within a County

- A rural Virginia county wishes to acquire the water treatment assets of a local homeowner's association and connect them into a larger countywide system. The cost of the acquisition is $3 million.
- The homeowners will benefit significantly from greater reliability and existing county customers will benefit by being able to spread operating costs over a larger user base.
- The users of utility system typically pay for its operation so this would indicate a revenue bond structure.
- The Seven Questions:

1. Cash v. Debt?: The County does not wish to use general reserves to acquire the assets; debt is preferred.
2. Which Security? Likely a Revenue Bond (probably a moral obligation backstop as well if coverage is weak)
3. Which Funding Provider? High issuance costs for stand-alone issuance; VRA would be a good alternative.
4. Affordability? Will need to have independent consultant confirm for VRA that rates meet certain requirements
5. The Team? Need Bond Counsel and either a Financial Advisor or Rate/Consultant/Engineer
6. Timing of Closing? Count on the financing process taking three to four months
7. Done Yet? Have Bond Counsel spell out post-sale disclosure responsibilities and make sure your Financial Advisor will monitor this debt for future savings opportunities.

Questions / Comments

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