

**Government of the District of Columbia
Office of the Chief Financial Officer**



Natwar M. Gandhi
Chief Financial Officer

June 20, 2007

The Honorable Adrian M. Fenty
Mayor of the District of Columbia
1350 Pennsylvania Avenue, NW - Suite 327
Washington, DC 20004

The Honorable Vincent C. Gray
Chairman
Council of the District of Columbia
1350 Pennsylvania Avenue, NW - Suite 504
Washington, DC 20004

Dear Mayor Fenty and Chairman Gray:

The purpose of this letter is to provide advice to the Mayor and the Council regarding the District's debt burden and its borrowing constraints. It is an update to a letter to former Mayor Williams and former Council Chairman Cropp on the same topic dated November 22, 2005. This subject matter is critical to the District's on-going financial health, and one that the Office of the Chief Financial Officer (OCFO) continually monitors and seeks to effectively manage.

It is crucial that the District implement and adhere to policies and practices that ensure current and long-term financial health. Therefore, the OCFO urges strict adherence to a debt cap in order to avoid negative impacts on the District's financial future. The District currently has a legal debt cap, but it is the view of the OCFO that this legal debt cap allows for a higher debt burden than is financially prudent. As such, I recommend a "management" debt cap that is lower than the legal debt cap.

The District has the highest debt per capita of any major municipality in the nation (\$10,429 projected as of the end of FY 2007), and a high debt-to-full (property) value ratio (5.9% projected as of the end of FY 2007) compared to industry norms. These are two commonly used ratios for assessing a jurisdiction's debt burden.

The District's ratio of debt service-to-total expenditures (or revenues) is approximately 9%, and it is still reasonable compared to industry norms. This ratio is particularly important because it not only provides a statistical measure of a jurisdiction's debt burden, but it also directly reflects debt affordability and the extent to which a jurisdiction is consuming, and limiting the flexibility of, current and future operating budget resources.

Out of concern for the District's financial health and future, I recommend two targets and two firm caps with respect to the District's debt ratios. The firm caps should not be exceeded:

- First, based on an assessment of the District's debt burden in relation to industry standards and in the context of its broader financial characteristics, I recommend that the District establish a target of 10% and a firm cap of 12% on its debt service-to-total (General Fund) expenditures ratio. While this recommended 12% firm cap is obviously higher than the recommended 10% target (the level recommended in my prior letter), given the District's current debt levels and the various already-approved, important infrastructure projects and plans (some of which are associated with economic development projects), this revised cap recommendation allows for a modest amount of additional debt and should still prevent the District from jeopardizing the hard-earned improvements in its bond ratings and its financial health achieved in recent years. This level of debt could, however, limit further improvements in the District's credit ratings.
- Second, I also recommend that the District establish a target of 6% on its debt-to-full value ratio, with a firm cap of 8% on this ratio.

It would be ideal for the District's debt ratios to be significantly lower than the recommended firm cap levels, which is why the (lower) target levels are also recommended. Still, the firm cap levels would allow the District to fund its substantial, already-planned and already-budgeted capital infrastructure needs (including schools modernization) while providing a reasonable level of additional future annual capital project expenditures, which should not produce debt levels that would, in and of themselves, adversely impact the District's bond ratings or compromise its long-term financial health. New initiatives that call for high levels of borrowing (via tax-supported debt) may have to displace currently-planned project(s) in order for the District to remain within the recommended caps.

All three of the rating agencies (Moody's, Standard & Poor's, and Fitch) have indicated that they consider the District's debt burden to be relatively high. Such high debt burden is a contributing factor to limitations on the potential for further bond rating upgrades. Bond ratings have a direct financial effect because they are a key determinant of the amount of interest that the District must pay on its debt, and bond ratings also represent a broad indicator to investors and other stakeholders of a jurisdiction's current and long-term financial health.

Debt-funded projects that create or enhance tax base and therefore create or improve a tax revenue stream can eventually have a positive effect on the debt-to-full (property) value ratio, which is currently high. And from a budget perspective, a project that has an associated tax revenue stream is financially preferable to those that do not.

Debt-funded projects with an associated, new stream of tax revenue, however, negatively impact the ratio of debt service to expenditures as calculated by rating agencies and other credit analysts, because they are considered net tax-supported debt. For example, if an issuer has \$100 of revenues and spends \$10 on debt service, its debt service ratio is 10%. If it uses another \$10 of

debt service to create a project that is “self-supporting” – that is, it generates \$10 in additional revenues – the total revenues are then \$110 and the total debt service is \$20, causing the debt service ratio to increase to over 18%. Although the project is “self-supporting”, the debt service ratio has increased significantly. This is not to say that the District should not take on projects that are expected to be paid from newly generated tax revenues, but decision makers must be aware that rating agencies and other credit analysts consider nearly all borrowing, with the few exceptions noted below in the attached appendix, tax supported debt.

In light of the distinct analysis and management that is warranted for debt that is to be supported by revenues directly related to the project(s) that such debt finances, the OCFO is also recommending the establishment of an Economic Development Capital Fund (EDCF). This recommended Fund, also described as an Internally Self-Supporting Debt Fund, would be a separate pool of funds for capital projects for which the debt service on such borrowed funds is expected to be covered by future revenues directly associated with the respective projects financed by such borrowing. As existing projects are repaid from the new revenues, this fund would restore borrowing capacity that could be used for new projects.

The debt issued pursuant to the EDCF would be subject to the overall debt caps, but would have a distinct borrowing capacity associated with it, as a subset of the District’s overall borrowing capacity as determined by the debt caps. The OCFO recommends an EDCF cap of \$1.5 billion. This can be accomplished within the overall firm cap of 12% along with all other currently-planned authorized debt. This \$1.5 billion cap is roughly the total amount (existing plus planned) that is already incorporated into our debt burden projections. This level recognizes that EDCF debt does benefit the city via the associated economic growth. Approximately \$350 million of this \$1.5 billion has been borrowed to date, but substantial amounts have been approved or are pending approval, which would utilize most of this \$1.5 billion. Approximately \$200 million (in TIFs/PILOTs) remains unearmarked and at the disposal of policymakers, so long as the Community Benefits Fund operates in part on a pay-as-you-go basis, the proposed District CIP proceeds with no additional debt in the financial plan years beyond what is already planned, and a 12% cap is imposed on total debt service to total expenditures.

The OCFO will continually monitor the debt ratio levels in relation to the recommended caps, and advise the Executive and the Council on an on-going basis accordingly.

If you have any questions regarding this matter, please do not hesitate to contact me.

Sincerely,



Natwar M. Gandhi
Chief Financial Officer

Attachment: Debt Burden and Borrowing Constraints

cc: The Honorable Carol Schwartz (At-Large)
The Honorable David Catania (At-Large)
The Honorable Phil Mendelson (At-Large)
The Honorable Kwame R. Brown (At-Large)
The Honorable Jim Graham (Ward 1)
The Honorable Jack Evans (Ward 2)
The Honorable Mary M. Cheh (Ward 3)
The Honorable Muriel Bowser (Ward 4)
The Honorable Harry Thomas Jr. (Ward 5)
The Honorable Thomas Wells (Ward 6)
The Honorable Yvette M. Alexander (Ward 7)
The Honorable Marion Barry (Ward 8)
Dan Tangherlini, Deputy Mayor and City Administrator
Eric Goulet, Budget Director, Council of the District of Columbia

BACKGROUND AND ANALYSIS

Types of Bonds

General Obligation Bonds

The District finances a majority of its capital projects via the issuance of long-term general obligation bonds, as do many other municipal jurisdictions. The term general obligation bonds (G.O. bonds) indicates that they are obligations payable from any available “general” revenues of the government, and that they are backed by the “full faith and credit” of the District. The debt service (principal and interest) payments on the bonds are a part of the District’s annual General Fund operating budgets. The District currently has approximately \$3.8 billion of G.O. bonds outstanding, and the annual debt service on those bonds was \$371 million in FY 2006.

Enterprise Revenue Bonds

Another major category of bonds are issued to support public enterprises like the District’s water and sewer system bonds issued by WASA. WASA functions as a public enterprise, or business, supplying water and sewer services in exchange for fees based on usage. It does not have taxing power, only the revenues generated by operation of the systems. Other examples of public enterprises include airports, municipal electric systems, and toll facilities, none of which the District currently owns or operates. Public enterprises, if they are to be considered “self-supporting” by rating agencies, must pay for all operating and capital expenses as well as debt service, from their own revenue streams, without transfers from a municipal General Fund. The enterprise revenue bonds issued by WASA do not count as part of the District’s debt ratios, either as debt per capita, debt to full value or debt service as a percent of revenues or expenditures.

Tax-Supported Revenue Bonds

The other major category of bonds that the District issues is tax-supported revenue bonds, meaning that the debt service on them is payable from defined, limited revenue stream(s). Such bonds are not payable from all available District revenues, but only the particular revenue stream(s) identified, and are not backed by the full faith and credit of the District. Examples of District revenue bonds are a) bonds issued by the Washington Convention Center Authority (WCCA) to build the new convention center, payable from certain District tax revenues assigned to WCCA and pledged to pay debt service on the WCCA bonds; b) bonds issued by the District to finance pre-development costs associated with the construction of the MCI Center, payable from the “Arena Fee” (gross receipts tax) levied on District businesses (the Arena bonds have been fully repaid), c) Ballpark Revenue Bonds payable from sales tax revenues at the stadium, utility taxes on non-residential customers, lease payments and revenues from the Ballpark Fee (gross receipts tax), and d) Tax Incremental Financings (TIFs) and Payment-In-Lieu-of-Taxes (PILOT) financings.

Although tax-supported revenue bonds are not general debt of the District like G.O. bonds, they are governmental debt, and must be considered in any assessment of the District's debt burden and its associated ramifications. More specifically, any debt that is payable from District tax revenues or General Fund revenues, whether G.O. bonds or tax-supported revenue bonds, is considered by the credit rating agencies as a part of the District's "tax-supported debt", which is their primary measurement in assessing a jurisdiction's debt burden.

Analysis

Bond Ratings and Debt Burden

Rating agencies assign credit ratings to the District's bonds, which directly reflect the agencies' views on the risk of non-payment of debt service by the District to bondholders. More broadly, however, the ratings reflect their assessment of the overall financial condition or financial health of an entity. Bond ratings are a key determinant of the interest rates that an entity must pay to borrow funds, and therefore such ratings have direct financial implications in addition to the broader implications regarding the status and direction of an entity's financial health and well-being. In determining the ratings assigned to an entity's bonds, the rating agencies assess a number of debt ratios that measure the level of its debt burden as part of assessing its overall financial condition.

High Levels of Debt and Planned Borrowing

The following table depicts the District's current and projected future status with respect to three key debt ratios in relation to the 2006 median of other large cities' ratios as documented by Moody's Investors Service. The projected ratios include all currently outstanding debt and assume that from now through 2011 the District will issue debt for the following, most of which is included in the proposed FY 2008 Budget and Financial Plan (and associated Capital Improvements Plan):

- the FY07 Capital Improvements Plan (CIP) for general governmental capital projects, approximately \$450 million annually), including the 15-year schools master facilities plan;
- the Master Equipment Lease/Purchase Program, providing shorter-term financing than bonds for assets with shorter (5-10 year) useful lives (approximately \$50 million annually);
- Schools Modernization Act (\$150 million, separate from amounts included above);
- Department of Transportation projects (approximately \$200 million, supported by parking tax revenues);
- Housing Production Trust Fund (HPTF) financing (approximately \$225 million, supported by dedicated HPTF revenues);
- Government Centers project (approximately \$175 million);
- various Economic Development Capital Projects (TIFs, PILOTs, etc.) (totaling an estimated \$600 million);

- a Convention Center headquarters hotel and convention center expansion (approximately \$300 million);
- Great Streets project (approximately \$64 million, supported by bus shelter revenues);
- Consolidated Laboratory Facility (approximately \$150 million);

(The projections in the table also account for the reductions in debt that will occur as a result of regular debt service payments on the current and projected debt over the indicated period.)

Effect of Projected Additional Debt on Debt Ratios - as of May 2007							
	Moody's 2006 Median for All Cities	Projected Overall Tax-Supported Debt at End of FY					
		2006	2007	2008	2009	2010	2011
Debt to Estimated Full Value	2.7%	4.9%	5.9%	6.7%	6.9%	6.9%	6.8%
Debt Per Capita (Median is from 2002)	\$1,992	\$ 8,709	\$ 10,429	\$ 12,320	\$ 13,217	\$ 13,690	\$14,102
Debt Service to General Fund Expenditures	8.6%	8.7%	8.9%	10.6%	11.9%	12.1%	11.8%

Analysis of Debt Ratios

As the ratios in the table indicate, the District's current and projected ratio for debt to estimated full (property) value is quite high in relation to the current Moody's Median. Despite the escalation in District property values in recent years, this ratio is still high at approximately 6% by the end of FY 2007, and is projected to grow to approximately 7% by 2009, assuming the additional debt indicated above.

In debt per capita (for which Moody's no longer calculates a median), the District is the highest in the nation, far higher than most other jurisdictions, with overall estimated tax-supported debt per capita at \$10,429 by the end of FY 2007. (Some of this is due to the District having to finance state-like capital projects over the years.)

In terms of the overall debt service-to-total General Fund expenditures ratio, the District will be at approximately 9% by the end of FY 2007 and is projected to increase to approximately 12% by 2009. Traditionally, a debt service-to-total expenditures ratio above 10% has been viewed by many analysts in the industry as a "red flag" indicating movement into the high range. While there are numerous jurisdictions with ratios that exceed the 10% level, financial prudence dictates that the District establish a policy limit or cap that is at or not far in excess of this level.

Ideally, it would be preferable for the District to establish a firm cap at the 10% level, but given the District's current debt position and taking all relevant factors into consideration, the OCFO is recommending a target of 10% and a firm management cap at the 12% level. We believe that this recommended cap appropriately balances the District's current debt levels and planned important infrastructure projects with the need to avoid future debt levels that would produce an unhealthy financial future for the District.

In addressing debt policies that some jurisdictions put in place to contain their debt burden, Fitch Ratings states that "typical policies limit direct debt to 2-5% of full market value and/or \$2,000-\$3,000 per capita [and] debt service to 8-12% of budgeted expenditures...." While these policy limits refer to direct debt and not all tax-supported debt, and comparable policy limits were not cited for overall tax-supported debt, Fitch also states "a comprehensive policy will include all types of tax-supported debt."¹ Both Moody's and Standard & Poor's also state that they analyze all tax-supported debt in assessing a jurisdiction's debt burden.

Based on this research and direct communication with the rating agencies and advice from the District's financial advisors regarding the District's debt burden, the OCFO recommends the implementation of a management cap on its debt (in addition to the District's existing legal debt cap), utilizing the debt-to-full value ratio and the debt service-to-total expenditures ratio as the determinants. This latter ratio is particularly important because it not only provides a statistical measure of a jurisdiction's debt burden, but also directly reflects debt affordability and the extent to which a jurisdiction is consuming, and limiting the flexibility of, current and future operating budget resources. Specifics associated with this recommendation are provided in the Conclusion section of this attachment.

The ratios and projections shown above are a source of serious concern to the OCFO, and have been considered in determining recommended CIP borrowing levels and constraints to the Mayor and the Budget Review Team over the past few years. These concerns are not new. The OCFO understands the substantial District infrastructure needs, particularly with regard to DC Public Schools, and has sought to balance the infrastructure needs with the borrowing constraints in arriving at our recommended borrowing levels. We have discussed these issues at length with our financial advisors and with the rating agencies, and have expressed our commitment to doing everything in our power to manage the District's debt burden in a responsible manner. We have argued the District's case of "structural imbalance", and have indicated that a key component of the structural imbalance is the inability to sufficiently fund the District's vast infrastructure needs, including schools.

"Mandatory Expenditures," including Debt Service, are Consuming an Increasing Portion of Operating Budget

An additional, related concern that should be noted is the trend of "mandatory expenditures," with debt service as chief among them, increasing as a percentage of the District's budgeted expenditures. This obviously has the effect of reducing the Mayor's and the Council's discretion

¹ Source: Fitch Ratings, "To Bond or Not to Bond: Debt Affordability Guidelines and Their Impact on Credit", June 2005

regarding future budgeting flexibility and the ability to fund various governmental functions and programs. The attached chart shows that these expenditures were at a low point of 12.8% in 2001, are currently at 15.6%, and are projected to increase to 19.2% by 2010. These numbers provide another incentive to carefully manage the amount of additional debt incurred by the District, in order to avoid unduly constraining policymakers' future budgeting options.

Conclusion

Implement Caps on Debt

As indicated above, in consideration of all relevant information, the OCFO recommends that the District implement a firm management cap on its debt, using as determinants two debt ratios that the bond rating agencies have indicated that they highly value: the debt-to-full (property) value ratio and the debt service-to-total (General Fund) expenditures ratio on tax-supported debt. We recommend that there be a target level and a firm cap for each of these ratios, at 6% and 8%, respectively, for the former ratio, and 10% and 12%, respectively, for the latter ratio. This combination represents what the OCFO believes are prudent debt levels to maintain the District's solid financial status, allow for continued financial progress, and avoid jeopardizing its current bond ratings (and, as a result, increasing debt service costs).

Even now, with its current debt ratios, the District's debt burden is considered relatively high. In addition, given that the District has a financial foundation constrained by a limited tax base and must perform city, county and state functions without the desired level of resources or support (to which the high debt ratios are partly attributable), it is our position that the recommended debt caps represent debt levels above which the District would begin to risk compromising and jeopardizing its financial health, future and bond ratings. Declines in the District's bond ratings would not only represent regression in terms of the District's financial viability as judged by the financial marketplace, but would also mean that its future financings would be at higher interest rates, costing the District additional debt service dollars in its annual operating budgets. The District has a statutory legal debt limitation on its G.O. debt, but not for its overall tax-supported debt. Moreover, the G.O. debt limit, which states that maximum annual debt service cannot exceed 17% of total current-year revenues, provides a relatively liberal debt cap that does not impose the level of fiscal prudence necessary to maintain the District's financial health.

In their most recent rating reports on the District, all three of the rating agencies (Moody's, Standard & Poor's, and Fitch) indicated that they consider the District's debt burden to be relatively high. In its 2005 assessment of the District's financial condition during the process of rating a new District general obligation bond issuance, Fitch indicated that the District's high current and projected debt levels were a significant factor in their deciding not to further upgrade the District's rating at that time. Despite this fact, and through the significant efforts and vigilance of the Mayor and the Council that contributed to a strong economy and sound financial management, the District has steadily improved its financial condition and obtained a series of credit rating upgrades from the rating agencies over the past several years. The District's financial recovery since the mid-1990s and its elevation from below investment-grade (or "junk bond") status to its current "A"-category credit ratings was hard-earned, and the District must

continue to be vigilant in maintaining financial policies and practices that protect those hard-earned gains and keep the District progressing towards increased long-term financial health. The OCFO believes that the recommendations provided in this letter are consistent with staying on that course.

In order to keep its debt within the recommended caps, the District must, during the financial plan period, be very judicious about adding new tax-supported debt-financed initiatives beyond what is already included in the proposed FY 2008 Budget and Financial Plan, unless such new initiatives are prioritized to displace currently-planned project(s). The OCFO stands ready as a resource to assist policymakers in conducting the necessary analysis on an on-going basis to ensure that the District stays within the recommended caps.

Establish an Economic Development Capital Fund (Internally Self-Supporting Debt)

In evaluating different types of debt, it is clear that debt-related initiatives that have an associated revenue stream are financially preferable to those that do not. In the case of TIFs and PILOT financings, the ultimate goal is to increase the District's tax base. As a result, they can eventually positively impact one of the debt ratios, namely, the debt-to-estimated-full (property) value ratio.

In light of the distinct analysis and management that is warranted for debt that is to be supported by revenues directly related to the project(s) that such debt finances, the OCFO is also recommending the establishment of an Economic Development Capital Fund (EDCF). This recommended Fund, which may also be described as an Internally Self-Supporting Debt Fund, would be a separate pool of funds for capital projects for which the debt service on such borrowed funds is expected to be covered by revenues directly associated with the respective projects.

Debt that qualifies as "self-supporting debt" from the perspective of the rating agencies, such as Enterprise Revenue Bonds as described above and certain other forms of revenue bonds that are repaid solely from a project's own revenue streams without transfers from a municipal general fund, are excluded from the rating agencies' calculation of "net tax-supported debt" as they assess a jurisdiction's debt burden. While the debt issued pursuant to the recommended EDCF may not meet the criteria for being considered self-supporting debt by the rating agencies, the District would consider it internally self-supporting debt if it has or is expected to have sufficient related revenues to cover the debt service on the bonds issued to finance the project(s). The debt service on such debt would, however, be included in the total of net tax-supported debt.

The OCFO recommends an EDCF cap of \$1.5 billion. This can be accomplished within the recommended overall firm cap of 12% along with all other currently-planned authorized debt. This \$1.5 billion cap is roughly the total amount (existing plus planned) that is already incorporated into our debt burden projections. This level recognizes that EDCF debt does benefit the city via the associated economic growth. Approximately \$350 million of this \$1.5 billion has been borrowed to date, but substantial amounts have been approved or are pending approval, which would utilize most of this \$1.5 billion. Approximately \$200 million (in

TIFs/PILOTs) remains unearmarked and at the disposal of policymakers, so long as the Community Benefits Fund operates in part on a pay-as-you-go basis, the proposed District CIP proceeds with no additional debt in the financial plan years beyond what is already planned, and a 12% cap is imposed on total debt service to total expenditures.

In cases in which it makes sense to issue revenue bonds backed by these related revenues to cover the debt service on such bonds, the District should do so. However, in most cases it would be less expensive and more efficient to issue District G.O. bonds as opposed to revenue bonds, and then allocate the associated revenue from such projects to cover (pay for) the debt service associated with these general obligation bonds. This would allow for better and more coordinated management of the various economic development projects that are proposed to be funded with debt, such as TIF and PILOT financings. The OCFO, working with input from the Deputy Mayor for Planning and Economic Development, will present a more detailed plan on this Economic Development Capital Fund recommendation in the future.

Mandatory Local Expenditures As A Proportion of Budget: FY 1998 - FY 2011

	Actual FY 1998	Actual FY 1999	Actual FY 2000	Actual FY 2001	Actual FY 2002	Actual FY 2003	Actual FY 2004	Actual FY 2005	Actual FY 2006	Budgeted FY 2007	Budgeted FY 2008	Forecast FY 2009	Forecast FY 2010	Forecast FY 2011
Repayment of Loans and Interest	347,358	363,194	315,656	228,364	233,251	250,649	303,397	342,683	370,128	405,114	443,507	491,054	542,376	519,507
Certificates of Participation	7,926	7,929	7,929	7,929	7,924	2,280	4,752	10,952	10,941	31,225	32,288	32,541	32,790	33,045
Police and Fire Retirement System	47,700	35,100	39,900	49,000	74,600	68,900	96,700	112,100	117,500	140,100	137,000	143,850	151,043	158,595
Teacher's Retirement System	8,900	18,600	10,700	200	0	0	0	9,147	15,431	14,600	6,000	6,300	6,615	6,946
Other Post-Employment Benefits	0	0	0	0	0	0	0	0	138,000	4,700	110,907	86,200	91,800	97,700
WMATA Subsidy	126,746	131,604	135,531	163,073	148,493	154,531	159,122	165,303	187,615	198,487	223,309	260,947	297,720	273,434
Subtotal, Mandatory	538,630	556,427	509,716	448,565	464,268	476,360	563,971	640,185	839,615	794,226	953,011	1,020,892	1,122,344	1,089,227
Rest of District	2,229,119	2,320,423	2,624,143	3,064,304	3,045,208	3,194,666	3,266,029	3,583,861	4,127,026	4,291,972	4,616,822	4,544,026	4,721,122	4,952,315
Total	2,767,748	2,876,850	3,133,659	3,512,869	3,509,476	3,671,026	3,830,000	4,224,046	4,966,641	5,086,198	5,569,833	5,564,918	5,843,466	6,041,542
Percent Mandatory	19.5%	19.3%	16.3%	12.8%	13.2%	13.0%	14.7%	15.2%	16.9%	15.6%	17.1%	18.3%	19.2%	18.0%

FY 2006 total excludes financing transfers
 FY 2008/2009 totals include OPEB

