

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



Natwar M. Gandhi
Chief Financial Officer

July 8, 2008

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

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:

At a time when the national and regional economies are showing signs of significant stress, it is imperative that the city continue to follow the prudent fiscal and debt policies that have led to its current sound economic and financial position. The District currently enjoys the highest bond ratings ever, and there is good reason to believe that a continuation of these policies could lead to even greater savings of millions of dollars in interest payments annually.

Therefore, 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 my letter on the same topic dated June 20, 2007. Given current economic conditions, this subject matter is even more critical to the District's ongoing financial health, and one that the Office of the Chief Financial Officer (OCFO) continually monitors and seeks to effectively manage. As such, I reaffirm my June 2007 recommendation of a "management" debt cap that is lower than the legal debt cap. The District has the highest per capita debt of any state or major city in the nation. Debt service is projected to take a greater portion of the budget in the future, and I am therefore again recommending a target ratio of debt service-to-expenditures of no greater than 10 percent, and a firm cap of no more than 12 percent. This cap applies to all "tax-supported" debt obligations consistent with the definition commonly used by rating agencies and credit analysts.

It is crucial that the District adopt and adhere to policies and practices that ensure its current and long-term financial health. Therefore, the OCFO again strongly 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 of 17% of local revenues but it is the view of the OCFO that this legal debt cap allows for a higher debt burden than is financially prudent. Moreover, the legal debt cap applies only to General Obligation bonds, whereas rating agencies analyze all "tax-supported" debt, including certificates of participation, tax revenue bonds, and TIFs.

The District has the highest debt per capita of any major municipality in the nation (\$10,902 projected as of the end of FY 2008), and a high debt-to-full taxable property value ratio (4.9% projected as of the end of FY 2008), 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 9.7%, which is somewhat high, but still relatively 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.

The District's high debt levels reflect, at least to some degree, the effects of having to fund a substantial amount of infrastructure maintenance and improvement projects that were deferred during the period of fiscal stress in the 1990s, particularly for the public schools. We are now making up for those deferrals while at the same time attempting to keep current with the city's ongoing infrastructure needs. Deferral of this type of capital improvement is, in the long run, expensive and should be avoided.

Out of concern for the District's financial health and future, I reaffirm my recommendation of two targets and two firm caps with respect to the District's debt ratios, and that legislation be enacted to enforce these recommendations. 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 strongly recommend that the District adhere to a target of 10% (or less) and a firm cap of 12% on its debt service-to-total (General Fund) expenditures ratio. 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), the firm cap recommendation allows for a modest amount of additional debt and should prevent the District from jeopardizing its financial health and the hard-earned improvements in its bond ratings achieved in recent years. Abiding only by the firm cap and not the target, however, could limit further improvements in the District's credit ratings.
- Second, I also recommend that the District adhere to a target of 6% (or less) on its debt-to-full property value ratio, with a firm cap of 8% on this ratio.

New initiatives that call for high levels of borrowing (via tax-supported debt) may have to displace currently-planned projects in order for the District to remain within the recommended caps. (See Attachment 1.)

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 a high debt burden is a contributing factor to limitations on the potential for further bond rating upgrades forcing the city

to continue to pay higher than necessary interest rates. 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 a jurisdiction's 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, for the District, is currently high. And from a budget perspective, a project that has an associated tax revenue stream is financially preferable to one that does 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 such a project may be termed "self-supporting," the debt service ratio would be 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 in the attached appendix, tax supported debt.

For economic development projects, there is a pressing need for distinct analysis and careful management, especially when the debt is to be supported by revenues directly related to the project. Therefore, the OCFO also recommends establishing an Economic Development Capital Fund (EDCF). This fund would be a separate pool for economic development capital projects for which the debt service on borrowed amounts is expected to be covered by future revenues directly associated with the respective projects. Examples are TIF projects, the Ballpark bonds and the Convention Center hotel. As existing projects are repaid from the new revenues, this borrowing capacity would be restored and available for new projects.

The debt issued pursuant to the EDCF would be subject to the overall debt caps, but would have a separate 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 (with inflation growth beginning in 2014). (See Attachment 2.) 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 \$431 million of this \$1.5 billion has been borrowed to date, but substantial amounts have been approved or are pending approval, which would utilize all but \$122 million of this \$1.5 billion.

As shown in the chart below, through 2011 the ratio of debt service-to-total expenditures is projected to rise and come very close to the recommended 12% hard cap (11.8%), and then gradually decline in subsequent years (based on the scheduled amortization of existing debt and the expected annual growth in expenditures).

Estimated Effect of Projected Additional Debt on Debt Ratios - as of June 2008								
	Moody's 2006 Median for All Cities	Projected Overall Tax-Supported Debt at End of FY						
		2007	2008	2009	2010	2011	2012	2013
Debt to Estimated Full Value	2.7%	4.8%	4.9%	5.4%	5.5%	5.5%	5.3%	5.2%
Debt Per Capita (Median is from 2002)	\$1,992	\$ 10,119	\$ 10,902	\$ 12,327	\$ 13,209	\$ 13,538	\$13,772	\$13,999
Debt Service to General Fund Expenditures	8.6%	9.1%	9.7%	11.0%	11.8%	11.8%	11.3%	11.1%

These projections include an assumed annual rate of growth in the District's revenues and expenditures of 4%. The projections also assume annual borrowing of approximately \$400 million over the financial plan period to fund new general capital expenditures in the District's on-going Capital Improvements Program (CIP), including schools modernization, plus funding for the already-approved and budgeted Government Centers, East Washington Traffic Initiative, and Consolidated Laboratory Facility projects. Also included in the projections is planned annual borrowing of approximately \$40 million through the District's Master Equipment Lease/Purchase Program for intermediate-term capital assets. The table below shows the schedule of planned and/or approved borrowing that forms the basis of the ratios above. It also shows, based on projections, the approximate adjustments that would be needed to the planned/approved borrowing in order to meet the 10% target level, and the amounts of additional debt, whether for general capital improvements or for economic development projects, that could be incurred over the financial plan period while remaining within the 12% recommended cap¹:

¹ Amounts are approximate and are based on a 25-year, level debt service structure. Actual borrowing capacity will depend on the structure and duration of the bonds or notes, as well as market interest rates at the time of the transaction.

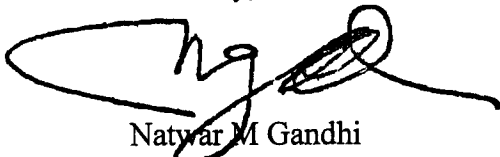
(S in millions)			
Fiscal Year	Planned/ Approved Borrowing	Adjustments to meet 10% Target	Additional Debt within 12% Firm Cap
2009	\$1,175	(\$1,175)	\$0
2010	879	(\$879)	\$200
2011	557	(\$307)	\$50
2012	496	(\$196)	\$200
2013	484	(\$109)	\$250

Beyond 2013, we project that the annual CIP borrowing and Economic Development borrowing could increase by 4% annually (beginning in 2014) and remain within the recommended debt caps.

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

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

Sincerely,



Natwar M Gandhi
Chief Financial Officer

Attachments

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)

Currently Planned Borrowing For Projects

(\$ in millions)

	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
GO Bonds:					
Annual GO bonds, including schools modernization	\$ 449	\$ 447	\$ 444	\$ 446	\$ 447
Government center bldgs	75	-	-	-	-
East Washington traffic initiative	50	88	50	-	-
Consolidated Laboratory	75	50	-	-	-
Sub Total GO Bonds	<u>649</u>	<u>585</u>	<u>494</u>	<u>446</u>	<u>447</u>
Master Lease	61	39	34	40	37
Economic Development Projects *					
Housing Production Trust Fund	50	140	-	-	-
Convention Center Hotel TIF	187	-	-	-	-
Downtown Retail Priority Area (DR	17	-	-	-	-
Madame Toussauds TIF (DRPA)	3	-	-	-	-
Radio One TIF	-	8	-	-	-
Rhode Island Place RPA TIF	7	-	-	-	-
Southeast Federal Center PILOT	30	60	-	-	-
Capper Carrollsburg PILOT	55	-	-	-	-
Great Streets RPA TIF	19	48	29	-	-
Fort Lincoln RPA TIF	10	-	-	-	-
Skyland RPA TIF	40	-	-	-	-
O Street Market	47	-	-	-	-
Subtotal Econ Dev Projects	<u>465</u>	<u>256</u>	<u>29</u>	<u>10</u>	<u>-</u>
Total	\$ 1,175	\$ 879	\$ 557	\$ 496	\$ 484

* Southwest Waterfront project authorized for \$198 million not expected to be issued until 2014.

Summary of Economic Development Debt *

	Authorized Amount (\$ in millions)	
ISSUED TIF/PILOT Projects		
International Spy Museum TIF	0.00	
Mandarin Oriental Hotel TIF	45.99	
Gallery Place Mixed Use Development TIF	73.65	
Embassy Suites Hotel TIF	11.00	
Capitol Hill Towers Development TIF	10.00	
DC-USA Retail Development TIF	46.90	
Shakespeare Theatre TIF	10.00	
H&M TIF (part of DRPA)	2.90	
West Elm TIF (part of DPRA)	5.00	
Zara TIF (part of DPRA)	1.75	
US Department of Transportation PILOT	140.00	
Total	\$347.19	
OTHER DEBT		
Verizon Center Revenue Bond	50.00	
Housing Production Trust Fund Revenue Bond	34.10	
Total	\$84.10	
TOTAL ISSUED	\$431.29	
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		Proposed/Assumed Issuance Dates
AUTHORIZED TIF/PILOT Projects **		
Downtown Retail Priority Area TIF (DRPA)	17.35	FY 2009
Madame Toussauds TIF (part of DRPA)	3.00	FY 2009
Fort Lincoln Retail Priority Area TIF	10.00	FY 2009
Rhode Island Place Retail PILOT	7.20	FY 2009
Southeast Federal Center PILOT	90.00	FY 2009 - 2010
Capper Carrollsburg PILOT	55.00	FY 2009
Radio One TIF	8.00	FY 2010
Great Streets Retail Priority Areas TIF	95.00	FY 2009 - 2011
Total	\$285.55	
OTHER DEBT		
Housing Production Trust Fund Revenue Bond	190.00	FY 2009 - 2010
Convention Center Hotel TIF	187.00	FY 2009
Total	\$377.00	
TOTAL AUTHORIZED NOT YET ISSUED	\$662.55	
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PROPOSED TIF/PILOT Projects		
Skyland Retail Priority Area TIF	40.00	FY 2009
Southwest Waterfront	198.00	FY 2014
O Street Market	46.50	FY 2009
Total	\$284.50	
TOTAL ISSUED, AUTHORIZED AND PLANNED	\$1,378.34	
REMAINING AUTHORITY WITHIN RECOMMENDED CAP	\$121.66	FY 2014
TOTAL ECONOMIC DEVELOPMENT DEBT	\$1,500.00	

* Rating agencies consider nearly all borrowing, with few exceptions such as the Tobacco Settlement Asset-Backed Bonds, tax supported debt.

** Excludes \$10.75 million authorized for Children's Museum, but not expected to be issued.