City of Alexandria, Virginia

MEMORANDUM

DATE: APRIL 8, 2002

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: PHILIP SUNDERLAND, CITY MANAGER PS

SUBJECT: BUDGET MEMO # 10 : ACCELERATION OF BOND ISSUES (COUNCILMAN SPECK AND COUNCILWOMAN EBERWEIN'S REQUEST)

During the last budget work session, Councilman Speck and Councilwoman Eberwein asked if the $28.0 million in bonds planned to be issued in FY 2004 and the $20.0 million bond issue planned for FY 2005 could be issued earlier to take advantage of the current low interest rates. Acceleration is not recommended for a combination of reasons. It is the combination of these reasons, rather than a single reason, which leads to the recommendation not to accelerate the City's bond issuance schedule. These are explained in greater detail in this memorandum. These reasons are:

1. The view of the bond rating agencies of another accelerated bond issuance by the City,
2. The effects of negative arbitrage,
3. The relative small change in the long-term tax-exempt interest rates, and
4. The federal thirty-six month requirement of spend-down of tax-exempt bond proceeds.

1. The View of the Bond Rating Agencies. During our last two presentations to the rating agencies, we stated that the City was accelerating our bond issuance schedule compared to what was proposed in the City's Approved Capital Improvement Program. In 2000, we increased the size of our bond issuance by $15 million from $40.0 million to $55.0 million primarily to accelerate the conversion of the City's bond financing practice from the "reimbursement" to the more common "prospective" financing approach. In 2001, we increased the size of our bond issue by $24.0 million from $30.5 million to $54.5 million to take advantage of favorable interest rates. In 2001 we also told the rating agencies that because of the acceleration of the $24.0 million, the next City bond issue would be in 2003. With two successive accelerations, combined with the fact that these two City bond issuances increased City bond debt from $59.7 million in May 2000 to $163.0 million by August 2001, the rating agencies are likely to look unfavorably on the ability of the City to manage its capital spending if additional debt were issued now.

Strong fiscal management has been, in the eyes of the rating agencies, one of the City's strong points. Also, there are still outstanding issues that may increase capital bonding needs in FY 2004 beyond what is in the CIP. For example, T. C. Williams High School capital costs may exceed what is currently in the CIP, and the capital costs of addressing space and parking needs at the Public Safety Center may be substantial. As a result, the $28 million bond issue planned for FY 2004 may need to be larger than what is now contemplated. Therefore, it would be better to present to the bond rating agencies a single larger bond total in FY 2004 (or late FY 2003, if needed) rather than an accelerated bond issuance now, and then a totally new bond issue in FY 2004. Also, it is inadvisable to borrow for projects where the scope, size and timing of the projects have a high degree of uncertainty.

2. Negative Arbitrage. Arbitrage for State and local governments refers to the difference between the interest paid on the tax-exempt bonds and the interest earned by investing bond proceeds in usually higher-yielding taxable securities prior to the bonds being expended on projects. The 1986 Tax Reform Act and subsequent regulations require that arbitrage earnings in excess of certain parameters (which approximate the interest rate paid on the bonds) be rebated to the federal government and impose strict documentation requirements pertaining to the timing of expenditures of bond proceeds[1]. The City earns interest in the period between the time the bonds are issued and the time the bond proceeds are fully expended on capital projects.

Negative arbitrage occurs when the interest earned on the bond proceeds is less than the interest paid on the tax-exempt bonds. This phenomenon occurs when the interest rate on short-term investments is less than the interest on longer term tax-exempt bonds. Exhibit 1 demonstrates that financial market data show this is one of the worst periods of negative arbitrage in the past decade. In such an environment, the benefits of accelerating the issuance of bonds in order to capture current tax-exempt rates can be reversed or countered by the low level of investment income on the invested bond proceeds.

The City normally invests its bond proceeds in the State Non Arbitrage Program (SNAP). This statewide investment pool program, which is managed by the Treasury Board of Virginia, provides a full range of related services including preparation of arbitrage calculations for the IRS, spend-down monitoring, legal and depository services. On March 15, 2002, the yield on an investment in SNAP was 1.98%, well below the 4.60% yield on a 20-year level principal financing at the current Municipal Market Data " Triple A" scale. On a $48 million financing (representing the City's FY 2004 and FY 2005 needs) accelerated by twelve months, the cost of this negative arbitrage would be $1.25 million over the first year. Exhibit 2 demonstrates the relationship between negative arbitrage and long-term tax-exempt rates on a $48 million financing. As the graph shows, this $1.25 million of negative arbitrage is the equivalent of a 0.35% increase in the interest rate on the bonds. Therefore, accelerating the bond issue by one year would be the appropriate financial strategy if tax-exempt rates are expected to rise by more than 0.35% over the course of the year. This may be a logical approach; however, it would certainly be more appealing if the impact of negative arbitrage could be reduced. We have explored several investment strategies (including interest rate swaps) with our financial advisor

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[1] There are some exceptions to the rebate requirement but they do not apply to the circumstances being discussed in this memorandum.

to reduce the impact of the negative arbitrage but none of the strategies completely eliminates the negative arbitrage.

3. Relative Small Change in Interest Rates. While media attention was focused on the Federal Reserve cut of short-term interest rates eleven times in twelve months to the lowest level in 40 years, tax-exempt long-term rates were creeping up without much publicity. Exhibit 3 depicts the interest rate by maturity on the AAA/Aaa bonds if issued in April 2001 compared to April 2002. As the chart shows, the short-term rates have dropped but the long-term rates have remained constant or increased.

The City issues bonds that usually have level principal payments over 20 years which results in the average bond to have a life of approximately 11 years. The bonds we issued last July had a True Interest Cost (TIC) or time weighted average interest cost of 4.599371%. If we issued today, despite all the Federal Reserve action, the average interest cost would be about the same, or close to 4.60 %. Exhibit 1 shows the Bond Buyer high-grade tax-exempt bond index over the past 12 years. Currently, long-term tax-exempt rates are still attractive based on historical levels and these rates have been below average for a period of approximately two years. Although we expect short-term rates to increase some in the next two years, as stated above, the City's financial advisors do not anticipate that the long-term tax-exempt rates will increase significantly. Historically, in relative terms tax-exempt municipal rates are more stable and do not drop as fast or as low as taxable bonds, nor do they increase as fast or as high as taxable bonds.

4. Restrictions on Spend-Down of Tax-Exempt Bond Proceeds. As a better financial practice, the City now has the financing of a capital project (including issuing bonds) in place before bids are accepted on the construction of the capital project. Depending on the complexity of the project, the actual payments to a vendor may occur as late as a year or two or three after bids are accepted on the capital project. Also, as a nearly universal truth in government construction, for various reasons the actual timing of construction projects is often later than when originally proposed by an implementing department. As a result, there is a significant period of time between when the bonds are issued and when the proceeds are fully expended. In order to maintain the tax-exempt status of the bonds, the government issuing the bonds must have a reasonable expectation at the time of issuance that all the bond funds will be spent within thirty six months. The IRS does allow proceeds to remain unspent after three years if there are valid reasons for any delay in spending that occurred after the bonds were issued (e.g. bidding problems, planning or construction delays, strikes).

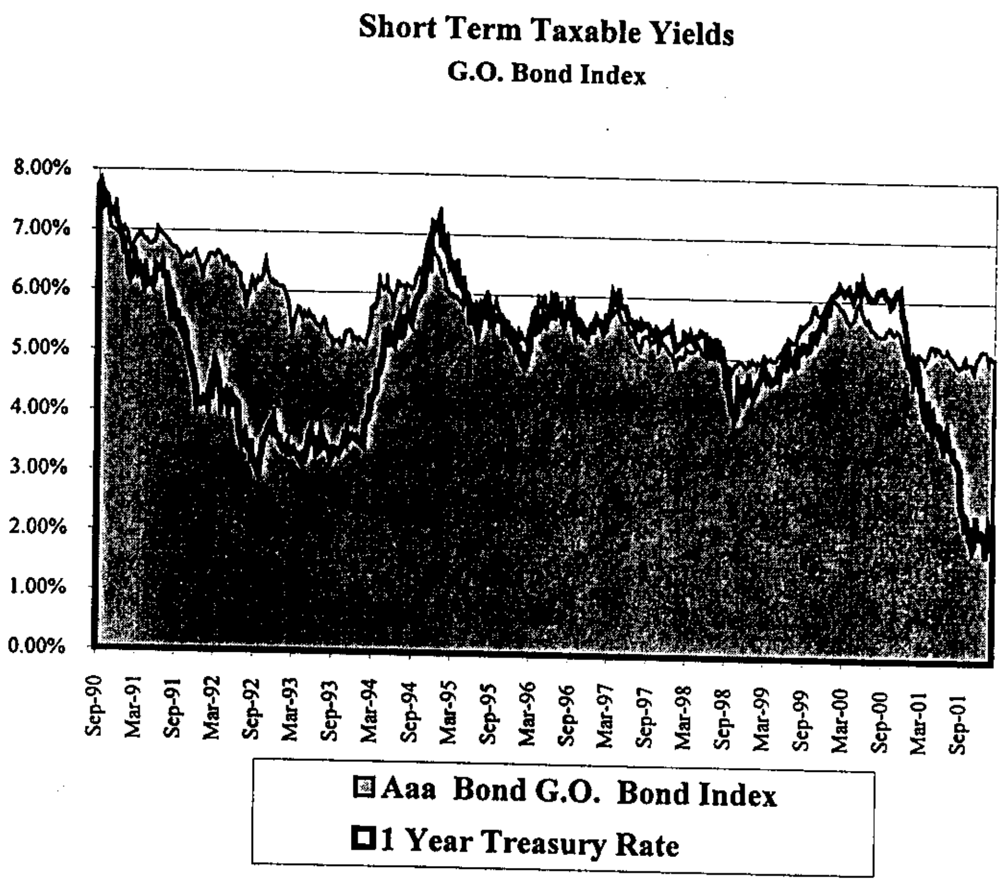
Even though the City has allocated portions of the 2001 Series Bond, which we issued last summer, to capital projects and has started construction on projects being financed by the 2001 Series Bonds, to date we have not spent any of the $55 million in 2001 Series Bond proceeds. We are not likely to be able to accelerate the issuance of the proposed FY 2004 bonds and

FY 2005 bonds because the City does not have the current ability to spend the proceeds within three years of issuance. This would also be the case if the City focused on spending its bond proceeds first, and its cash capital contributions second.

Exhibits:
1. Short Term Taxable Yields - G.O. Bond Index
2. Impact of Negative Arbitrage vs. Long Term Borrowing Rates
3. Comparison of Interest Rates on Bonds

Staff: Mark Jinks, Assistant City Manager
Daniel Neckel, Director of Finance

Exhibit 1



Note: Source - Bond Buyer 11-Bond G.O. Index

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Exhibit 2

Impact of Negative Arbitrage vs.
Long-Term Borrowing Rates
$48 MILLION LEVEL PRINCIPAL

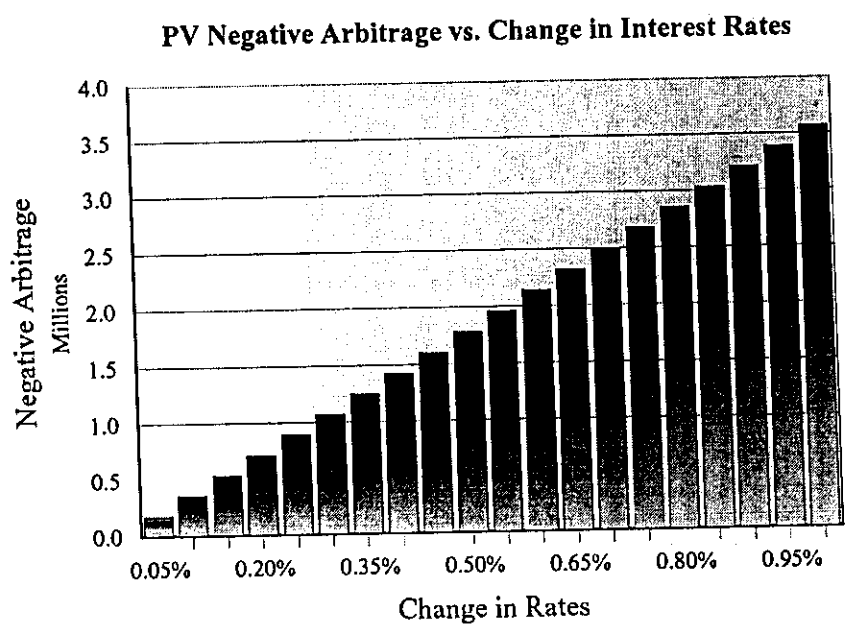
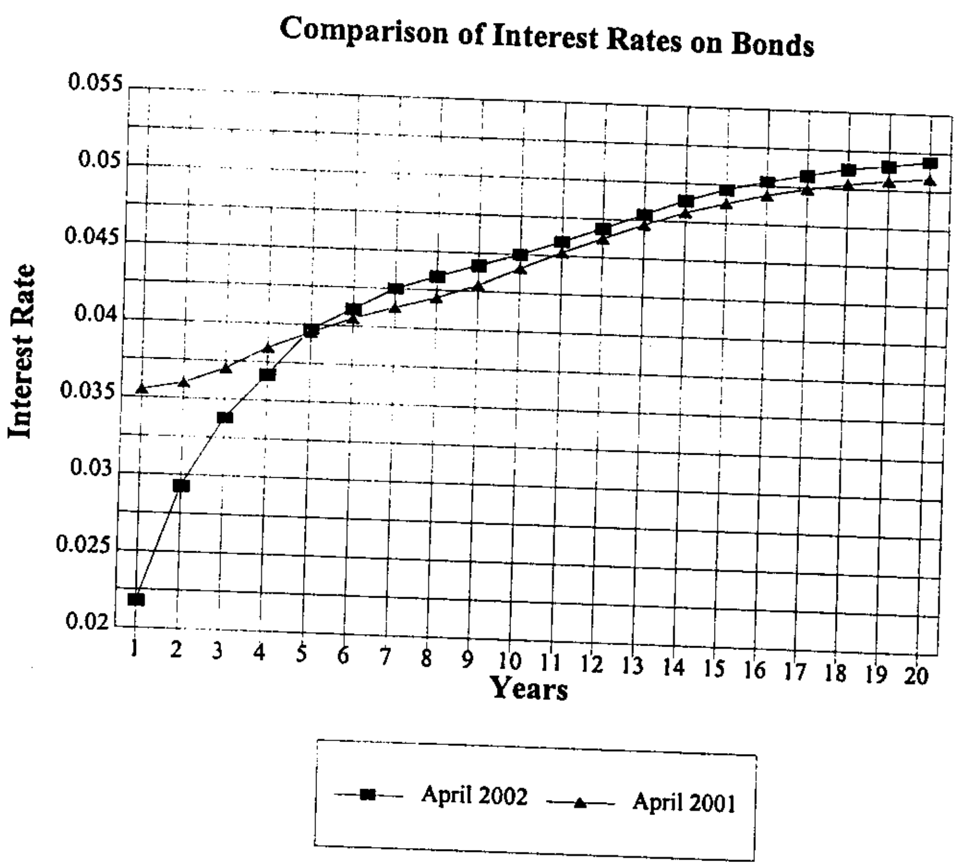


Exhibit 3


Comparison of Interest Rates on Bonds
0.055
0.05
0.045
0.04
0.035
0.03
0.025
0.02
Interest Rate
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20
Years
April 2002
April 2001