

# City of Alexandria, Virginia

## MEMORANDUM

DATE: MARCH 15, 2003

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: PHILIP SUNDERLAND, CITY MANAGER <sup>PS</sup>

SUBJECT: BUDGET MEMO #4: BUDGET AND FISCAL AFFAIRS ADVISORY  
COMMITTEE REPORT ON CITY FINANCIAL POLICY GUIDELINES

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During the FY 2004 budget process, the City Council charged the Budget and Fiscal Affairs Advisory Committee (BFAAC) with reviewing and, if appropriate, recommending changes to the City's financial policy guidelines related to debt targets and limits. BFAAC has completed its review, and its final report is attached.

The Tuesday, March 16, budget work session will include a presentation of the FY 2005 Proposed Capital Improvement Program (CIP) and a discussion of the CIP's impact on the City's debt targets and limits under the current policy and the revised policy as recommended by BFAAC.

Members of BFAAC will attend the work session and be prepared to address any questions you may have at that time.

Attachment: BFAAC Report on City Financial Policy Guidelines

cc: Mark Jinks, Assistant City Manager  
Bruce Johnson, Director, OMB  
Dan Neckel, Director, Finance

**City of Alexandria Budget and Fiscal  
Affairs Advisory Committee**

**Report on City Financial Policy Guidelines**

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## SUMMARY

The previous Council charged the Budget and Fiscal Affairs Advisory Committee (BFAAC) with reviewing the City's current Financial Policy Guidelines (also known as the Debt Policy Guidelines) and, if BFAAC thought it appropriate, recommend any changes in the policy.

BFAAC has studied the issue and makes the following recommendations:

1. Council should revise the Debt per Capita v. Per Capita Income guideline, to ensure that its output is more in line with the Debt v. Real Property Value indicators and comparisons with other jurisdictions.
2. Council may exempt capital projects paid for by the sewer connection and sanitary sewer fees from the Guidelines. Those CIP items are scheduled to be entirely funded through dedicated fees by FY 2007. As a result, it is not necessary to include them in calculations of the City's overall debt limits for the general fund.
3. Staff should periodically conduct a survey of other double triple-A jurisdictions to evaluate the remaining indicators to ensure that the City's debt limits remain in line with the averages of these jurisdictions.

## BACKGROUND

The City's Financial Policy Guidelines were set six years ago, in December 1997. At that time, Council adopted BFAAC's recommendations and established the following Guidelines related to debt:

### Current Financial Policy Guidelines

Indicator	Target	Limit
Debt as % of Fair Market Value of Real Property	1.10%	1.60%
Debt Per Capita as % of Per Capita Income	2.25%	3.25%
Unreserved General Fund Balance as % of General Fund Revenue	N/A	10.0%
Undesignated General Fund Balance as % of General Fund Revenues	4.0%	5.5%
Debt Service as % of General Government Expenditures	8.0%	10.0%
Unrestricted Net Assets as % of General Revenues	4.0%	5.5%

During the FY 04 budget process, BFAAC noted the growing discrepancy between the targets and limits as defined by Debt as a % of Fair Market Value of Real Property and Debt Per Capita as a % of Per Capita Income. BFAAC suggested that Council might want to update the guidelines to resynchronize these indicators.

As a result of the concerns outlined above, Council asked BFAAC to review the City's Financial Policy Guidelines and to recommend changes where appropriate. That report and recommendations follow.

## **DISCUSSION**

This report only addresses the Debt Policy portion of the City's Financial Policy Guidelines, since those were the areas of Council concern. However, BFAAC has not observed any problems or issues with the other Financial Policy Guidelines, and continues to endorse them. Those policies include:

- The City will increase its reliance on current revenue to finance capital improvements.
- The City will consider a designation for pay-as-you-go capital a priority when additional General Fund resources become available at the end of a fiscal year.
- The City will not use General Fund equity to finance current operations for periods of longer than two years.
- The City will annually prepare a six-year Capital Improvement Plan.
- The City will not issue tax or revenue anticipation notes to fund governmental operations.
- The City will not issue bond anticipation notes for a term of longer than two years.

BFAAC notes the Financial Guidelines serve as an important benchmark of fiscal stability and financial sustainability, and assist the City in maintaining its triple-A ratings.

BFAAC emphasizes that it is important that the City not exceed the debt limits. The City should plan on being at or below the targets. The difference between the targets listed in the Guidelines and the limits allows the City the leeway to finance unanticipated or emergency capital projects; planning to reach those limits could prevent the financing of such capital projects. It also could potentially jeopardize the City's triple-A bond ratings.

BFAAC acknowledges that debt that can be issued under the Debt Per Capita v. Per Capita Income guideline is lower than that of the Debt v. Real Property Value benchmark. Over the past few years, real estate assessments have seen double-digit annual increases, while income levels have increased in the single digits (if at all). In 1997 the Debt Per Capita v. Per Capita Income indicator was set to produce a result in line with the debt limits suggested by the Property Value indicator.

In addition, staff informs BFAAC that the market values of real property in the out years (2005-09) are based on estimates of 6% in annual assessment growth, although this rate of increase is approximately equal to that experienced over the last ten years, it may be conservative in the short-term. For example, the 2004 assessments, released February 10, 2004, show an 18.2% increase for residential property, further increasing the allowable debt under the Real Property Value indicator. Should the current trend of double-digit increases continue, Council would have additional leeway to finance new capital projects; however, per-capita income increases are not likely to be as great and these indicators will continue to diverge. As the Per Capita Income indicator was derived from the result of the Real Property Value indicator in 1997, it makes

sense to re-adjust it to better align with current realities, assuming that the results of the survey of benchmark jurisdictions do not indicate this would be a potential problem.

BFAAC acknowledges that the City appears to be closing in on the limit in the Debt Per Capita v. Per Capita Income indicator – especially when given the preliminary results of comparisons with other jurisdictions with triple-A bond ratings. Staff has indicated that Alexandria has a larger percentage of people living below the poverty line than do other jurisdictions with triple-A bond ratings. This fact could skew that guideline in comparison to the Real Property Value indicator. BFAAC notes that the City also has a higher per-capita income than do some other nearby triple-A jurisdictions, but those jurisdictions also have higher populations, thereby increasing their total debt capacity.

BFAAC finds no indication of problems with, or contradictions in, any of the other Debt Policy indicators established in the Financial Policy Guidelines.

That is not to say that there are no areas of potential concern. BFAAC cautions that the Historical and Projected Debt Ratios presented to the bond rating agencies in November show that debt service will total 5% of the City's operating expenses during the 2006-2007 timeframe. While this is well below the City's self-imposed limit of 10% and target of 8%, BFAAC does want to call Council's attention to the potential ramifications of higher debt service levels. The last time Debt Service v. Expenditure levels reached that height was in 1991-1992. Due to the real estate crash at that time, the City was forced to increase taxes and decrease spending on needed programs. While the financial version of such a perfect storm is not likely to recur, Council and Staff should be alert to early signs of slumping or depressed real estate assessments and valuations should they appear.

## **RECOMMENDATIONS**

### *Realigning Debt Per Capita v. Per Capita Income Indicator*

When the current Financial Policy Guidelines were adopted, BFAAC recommended and Council approved lowering the Debt per Capita v. Per Capita Income indicator by  $\frac{3}{4}$  of a percentage point – from 3% to 2.25% – so that it resulted in a target approximately equal to that allowed under the Debt v. Real Estate indicator. This target was set well below the average percentage of other triple-A jurisdictions. As a result, Staff has advised that an upward adjustment now should not affect the City's bond rating.

As mentioned in the discussion above, the Debt per Capita v. Per Capita Income indicator is out of sync when compared with other jurisdictions and the Debt v. Real Estate indicator. Those discrepancies can easily be explained and are not a cause for concern. Council can set the Debt Per Capita v. Per Capita Income target at 3.2% and set the limit at approximately 150% of that percentage. BFAAC observed in its Report on the Proposed Budget for FY 2004 that Council also might wish to update the Guidelines based on comparable data from other triple-A jurisdictions. Staff indicates that preliminary data shows that the average borrowing set by other triple-A jurisdictions is 3.47%, according to somewhat dated information.

**In order to bring the two indicators back into alignment, BFAAC recommends increasing the target to 3.2% and setting the limit at 4.5%. (Note: Numbers are tentative and need to consider information from an ongoing staff review of other jurisdictions.)**

*Exempting Capital Projects Financed Through Sewer Connection Fees and Sanitary Sewer User Fees from the Debt Limits*

Beginning with the FY 04 budget, capital improvements to the sewer system are financed through current and projected sewer connection fees and sanitary sewer user fees. The borrowings used for sewer capital improvements are included in the debt service calculations outlined in the Financial Policy Guidelines. Monies allocated to rebuilding and maintaining sewers cannot be used for other capital projects. The question is whether borrowings in effect supported by such a dedicated revenue stream should be included in the calculation of performance on these indicators when benchmark jurisdictions may not have equivalent financial practices.

City Staff have advised BFAAC that bond rating agencies will agree to exclude the dedicated sewer fees from their evaluation of the City's financial strength. As a result, Staff recommended that such fees be excluded from the Guidelines calculations, as inclusion is not therefore necessary in the calculation of debt limits for the General Fund.

**BFAAC concludes they may be excluded, and recommends that, once the sanitary sewer operating capital and debt service costs are fully fee-supported, that Council exempt debt-service related capital projects paid for by the sewer connection fees from the Debt Policy outlined in the Financial Policy Guidelines. BFAAC also suggests that this exemption may be used in calculating debt levels in the out-years on the current capital budget based on the currently projected 2007 self-sufficiency date for the system.<sup>1</sup>**

*Exempting Open Space Fees from the Debt Limits*

As with the sewer connection fees, the City beginning in 2004 will rely upon a portion of the real property taxes to finance open space acquisition under the Capital Improvement Program. Citing potential concerns among bond rating agencies, staff has indicated its reluctance to exempt open space fees from the debt limits. Because the open space set-aside is not a dedicated fee like the sewer fee revenues, rating agencies will not look upon it as a self-supporting program but would view debt and debt fee service costs related to open space as a regular part of the city's budget.

**As a result, BFAAC does not recommend Council consider exempting from the debt limits the amounts spent on open space capital projects.**

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<sup>1</sup> We recommend that an appropriate footnote be added to the Capital Budget to indicate year(s) in which self-sufficiency has been assumed. If the system does not become financially self-sufficient by FY 2007, BFAAC recommends that Council delay excluding sewer fees from the debt limits until such time as financial self-sufficiency is achieved.

### *Updating Indicators*

BFAAC recommends the City's Financial Policy Guidelines be reviewed every five (5) years to maintain an assurance that the performance of benchmark jurisdictions has not changed. However, too frequent reviews and opportunity for change may not provide the stability desired by the bond rating agencies. A five-year interval should provide that stability and, at the same time, provide for periodic prudent adjustments.

**As part of the five-year review, BFAAC recommends that Staff conduct a survey of the remaining indicators, using updated financial information, and updated demographic information from the 2000 Census, and the latest Department of Commerce income data to ensure that debt limits remain in line with the averages of other jurisdictions with double triple-A bond ratings.**