

DEBT SERVICE

Definition / Use of Debt

Prudent selection of the type of debt (long term bonds, equipment bonds, leases, etc.) has its advantages when financing is required and the large purchase cannot be readily financed in house. The City of Brewer has used all of these financing methods in the past.

State Law restricts the amount of debt that a municipality may incur by limiting it to a percentage of the total assessed value of the City. This is similar to the way banks limit the amount an individual may borrow to a standard debt ratio that compares the borrower's total indebtedness with their net worth. Specific restrictions are outlined in 30A MRSA, S#5072. The statutory debt limits of 15% of State taxable valuation are considered by most investment counselors to be too high.

In Brewer's case, a ceiling of 7.5% is the statutory maximum for each General Purpose Debt and Enterprise Debt. The 2017 State Valuation for Brewer is \$718,900,000. The maximum allowable General Fund debt would be 7.5% of this amount, or \$53,917,500. General fund debt on June 30, 2017 will be \$17,616,340, or 2.5%, of Brewer's State Valuation. WPCF debt on June 30, 2017 will be \$7,120,488, or 1%, and the Water Department debt will be \$11,573,012, or 1.6%.

Long Term Debt

Bonds of long-term duration (between 20 and 30 years) are typically best used for major capital projects such as schools, municipal buildings, major road construction, etc. The governing body of the community would typically issue long term debt for any or all of the following reasons:

- To spread the cost of the project over the life of the asset on to the taxpayers who will directly benefit from the project
- To avoid the difficult spike in taxpayer rates caused by using short term debt, current cash (taxes) or fund balance
- To Maintain a tax rate as low as possible while making necessary infrastructure improvements
- To take advantage of current low bond interest rates in order to finance some delayed capital construction

Types of Long Term Debt-

- 1) *General Obligation Bonds.* These General Purpose bonds are issued by the municipality and obligate all the taxpayer's property in the community as well as the City's property to be pledged to repay those bonds through taxation. This is the most common form of Long Term Debt because the best interest rates can be obtained by pledging all the assets of the City. These are typically issued on a tax-exempt basis, but can be issued as taxable bonds when the City is involved in a Public/Private economic development partnership.

- 2) *Revenue Bonds*. These are generally issued when dedicated sources of revenue are to be used exclusively for the debt service. An enterprise fund, such as a wastewater facility, might be an example if those additional user fees only, would be dedicated to repay the debt. However, the interest on these bonds is higher as the limited scope of the revenue stream is not as stable as the *General Obligation Bond*.

Short Term Bonds or Capital Equipment Bonds

These funding mechanisms are used when the assets being purchased are heavy vehicles, plows, graders, fire trucks, smaller construction projects, etc. For instance, a plow truck with an eight to ten year life should not necessarily use a long-term debt funding mechanism of 20 to 30 years. Additionally, the lending entity may not encourage this practice through its quote of charging higher interest rates on debt of longer duration. These notes are usually for five to eight years. The advantage of procuring monies through this method of borrowing is that the web of lending entities may be quite an extensive list of issuers, thus the community may be able to receive very competitive terms from local banks.

Capital Leases

This funding option is not so complicated as far as the legal process and is usually chosen when smaller projects and equipment are involved which can be easily leased because of the marketability of the items. A new fire truck or a sweeper on a ten-year lease might be fair examples. The advantage to the community can be from the wide variety of banks/companies bidding on the financing. This creates flexible leasing options where the City can choose an arrangement that works best in the long run for the financial or operational planning of the City. Another key advantage is that most leases have what is called a “non-appropriation clause” that basically allows the City to terminate the lease contract and its lease payment obligation by simply not appropriating the monies to fund that year’s lease payment. The result is that the City must return the equipment without any other obligations.

Some communities use the “leasing” option because it does not count as debt in calculating its debt ratios and total borrowing and it is also easier to sign a lease versus the more restrictive processes needed for issuing debt, such as special city charter votes, public hearings, opinions of bond Counsel, etc. Leasing does allow the City to consider annually whether or not to buy out the lease if it has raised funds and determined that the interest in the lease is now too high to tolerate.

Bonds-Can the City Refinance?

This is a general question that can only be answered by a specific review of each debt issuance. Maine Bond Bank loans cannot be refinanced at the municipality’s request because these debt obligations are rolled into a larger package at the State level to take advantage of a consolidated bond issuance. A private bond issuance can certainly have the call option incorporated in the loan documents but the municipality may experience a quarter point increase in the interest rate for the privilege of having a re-financing option after a minimum number of years.

Bond Ratings

Bond ratings are used to estimate and reduce the interest rate when placing City bond issues on the market as a stand-alone issue. It is much easier for the bonds to be sold when an identified rating has been established. If a city's debt obligations are already very high then the rating process can work against the City. At that point, for administrative ease as well as interest rate considerations, choosing to come under the wing of the Maine Bond Bank's borrowing capacity is usually the wisest path. The Maine Bond Bank usually issues its consolidated debt on a negotiated basis rather than a blind bid basis.

Another bond issue option that communities have is to issue their bonds on the open market using the services of a financial advisor to navigate the way through the funding process. These issues can be typically sold on a very competitive basis due to the use of the bid process along with what is simply called a bond insurance addendum that basically increases the rating of the city, or reduces its net interest cost of the financing. An "insured" bond broadens the marketability of the bond by re-assuring unfamiliar bondholders of the ability of the community to pay back its debt. See the next page for the City's current and past bond ratings.

What Do Bond Agencies Look For In A Borrowing Community?

Obviously, there are countless factors that make the lending agency evaluation process more complicated than can be easily summarized. However, some of the following points should be recognized as necessary considerations.

- Economic Base, or the foundation of a community's fiscal health
- The ratio of debt to State assessed valuation—Maine Bond Bank sees an average of 2-3% in their filings and discourages ratios above 5%
- Trends in the growth of the tax base
- Clean independent audits
- A regular and well documented budget process
- Debt management and schedules as well as total debt per capita
- Tax rates compared to Median Household Income ratios
- Sewer user fees that do not exceed 2% of Median Household Income
- A funded long term capital improvement plan
- Sufficient working capital reserves (i.e. Fund Balance) of 8.3% or more
- A stable non-property tax revenue stream
- Trends of expenditures and transfers between funds; signs of deviating from past policies can show signs of fiscal stress or strengthening
- Demographics of the taxpaying population
- Employment base

The above data, along with other factors, allows the rating agencies to compile an analysis to differentiate among various municipal bonds that may, on the surface, appear to be equally safe. These examples of what the bond rating agencies review should also be a good business indicator of what we as municipal officials should be aware of to maintain the fiscal health of the City.

Debt Statistics and Total Debt Listing

A detailed listing of the City's outstanding debt starts on page 5 of this section. The debt schedules for the Water Pollution Control Facility and the Water Department can be found in Sections Q and X, respectively.

Bond Ratings For The City

The following is a history of all of the rating actions taken by Moody's for the City.

| <u>Date of Action</u> | <u>Rating</u> | <u>Action</u> | <u>Date of Action</u> | <u>Rating</u> | <u>Action</u> |
|------------------------------|----------------------|----------------------|------------------------------|----------------------|----------------------|
| Jan-1938 | A | Initial | May-1990 | A | Confirm |
| Jan-1944 | Aa | Upgrade | Oct-1992 | A | Confirm |
| Nov-1956 | A | Downgrade | Dec-1992 | A | Confirm |
| Oct-1961 | A | Confirm | Oct-1993 | A | Confirm |
| Jun-1970 | A | Confirm | Aug-1995 | A | Confirm |
| Mar-1975 | A | Confirm | Aug-1996 | A | Confirm |
| Sep-1979 | A | Confirm | July-1997 | A3 | Refined* |
| Oct-1981 | A | Confirm | Apr-2000 | A3 | Confirm |
| Sep-1982 | A | Confirm | Oct-2001 | A2 | Upgrade |
| Sep-1984 | A | Confirm | Dec-2002 | A2 | Confirm |
| Sep-1986 | A | Confirm | Apr-2009 | A2 | Confirm |
| Aug-1988 | A | Confirm | Apr-2010 | Aa3 | Recalibration |
| Sep-1988 | A | Confirm | Jun-2012 | Aa3 | Confirm |

*Note: Since 1997, Moody's applies numerical modifiers (1, 2 and 3) in each rating classification from Aa to B. The modifier 1 indicates that the issue ranks in the higher end of its gradation; the modifier 2 indicates a mid-range; and the modifier 3 indicates that the issue ranks in the lower end of its category.

In October 2001, the City received a first-time rating of "A" from Standard and Poors. This rating was affirmed in December 2002 and again in September 2005. A review in April 2010 resulted in an upgrade to AA- with a Stable outlook, a rating which was affirmed in June 2012 and again in March 2014.