PUBLIC HEARING

ON

BILL 17-914, "LIMITATION ON BORROWING AND ESTABLISHMENT OF THE OPERATING CASH RESERVE ACT OF 2008"

Before the
Committee of the Whole
Council of the District of Columbia

The Honorable Vincent C. Gray, Chairman

September 22, 2008, 10:00 a.m.
Council Chambers

Testimony of
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Office of the Chief Financial Officer

Government of the District of Columbia

Good morning, Chairman Gray and members of the Committee of the Whole. I am Chief Financial Officer Natwar M. Gandhi. I am pleased to be here today to discuss the portion of Bill 17-914 that addresses the establishment of a limitation on borrowing.

The District's strong financial standing is testimony to the steadfast commitment of its elected leaders to sound fiscal management, which has resulted in a nearly $2 billion turnaround in the cumulative General Fund balance since 1996, from a $518 million deficit to a $1.5 billion positive balance. (See Attachment 1.)

This record of success is reflected in our bond ratings, which have been increased steadily over the past decade. It is a record we can be proud of, and one we must continue by adopting responsible financial policies and practices.

In my July 8, 2008 letter to Mayor and Council, I noted that the District's debt level, already considered high, continues to grow. Given current economic conditions and outlook for slower revenue growth, this subject is even more critical to the District's ongoing financial health. I will first address the need for a formal policy on debt issuance, and then I will address the recommended level of debt.

Need for A Formal Policy

The nature of debt service is that it is a mandatory expenditure, largely inflexible, that lasts for a very long time – as much as thirty years or more. With such long-term budget implications, it is imperative that governments carefully plan how to

fund capital projects, including those for economic development. The decision to fund a project with debt as opposed to other funding methods must take into consideration those long-term budget effects.

Attachment 2 to this testimony shows a history of the District's debt service as a percentage of spending. The substantial increase in borrowing in the mid-to-late 1990s increased debt service dramatically and produced additional strain on the District's finances. It was only through the use of bonds backed by revenues from the national settlement with tobacco companies that we were able to reduce debt service to more manageable levels. Since FY 2006 our debt service to expenditures ratio has begun to grow again, and is projected to come very near the recommended limit of 12 percent by FY 2010.

Questions have been raised as to the need to legislate a policy. The implementation of a formal policy as opposed to an informal policy would provide more reliable and effective assurance to all District stakeholders who benefit from having a financially strong government, to investors in the District's bonds, and to rating agencies who rate the District's bonds, that sound debt management policy has been institutionalized and is not a function of who holds a particular office at a given time. By adopting a formal policy on debt, we would reduce uncertainty about financial stability and assure a manageable level of debt for future generations of District residents.

What Should the Limit Be?

There has been a great deal of focus on our debt levels recently, which is indicative of the importance of this element to the District's overall financial condition. As we are all aware, the District performs more functions than most governments,

including those of a state, a county, a city and a school district. It has been suggested that it should therefore be acceptable for us to carry a greater percentage of our budget in the form of debt service.

This premise, however, suggests that 1) the fundamental financial analysis of how much debt an entity can reasonably afford to carry, given its size and revenue base, should not apply to us, and that 2) we can afford to allot a smaller percentage of the budget to all other functions, including the delivery of services to District residents. For example, if we set the limit at 12 percent of expenditures, we have 88 percent to spend on services. If we set the debt service limit at 14 percent of expenditures, we reduce the spending on services to only 86 percent.

In recent years, when revenue was growing at unprecedented levels, this may have seemed to be an acceptable option, since even if the percentage of non-debt service spending dropped, as in the "88 to 86 percent" example above, the dollar amounts may have actually grown. Now, however, with the growth of revenues and corresponding spending markedly slower, the smaller portion of the budget available for non-debt service spending could mean cutting services in future budgets.

We agree, however, that it is important not to set the policy limit too low. Standard & Poor's states that it "...looks for realistic debt limitations that permit an issuer to meet ongoing financing needs. A city near its debt limit has less flexibility to meet future capital needs, but more importantly, may be unable to borrow money in the event of an emergency."

All three of the rating agencies – Moody's, Standard & Poor's and Fitch Ratings – have indicated that they consider the District's debt burden to be high, with S&P referring to it as "very high". The tax supported debt per capita is $10,902, the highest of any state or major local government in the nation, and debt service as a percent of expenditures is almost 10 percent. Although it is tempting to finance many projects with debt, this will lead to diminished financial flexibility in the future if it is used excessively. It is imperative, therefore, that we look for ways to limit the amount of debt that we issue, including the use of annual pay-as-you-go (or Paygo) for capital projects.

Recommended Limit on Borrowing

The recommendation in my letter is to set a target to keep the share of our General Fund expenditures that goes to pay debt service at a level equal to no more than 10 percent of the total expenditures, with a firm cap of no more than 12 percent. The share of our expenditures that is used for debt service is currently 9.7 percent – under the recommended target of 10 percent, but above the Moody's Investors Service median for all U.S. cities of 7.8 percent[1]. Including expected future borrowing, that ratio is currently projected to reach 11.8 percent by 2010.

This recommendation was made after consultation with our financial advisors, carefully considering rating agency reports and criteria, and after years of discussion with rating analysts about the District's bond ratings. We also considered the unique role that the District plays as a state, a city, a county and a school district. We believe that the 12 percent firm cap is an appropriate policy for the District to adopt. It will ensure that future lawmakers will have sufficient operating funds to spend on delivering services to residents of the city.

[1] 2007 Local Government national Medians, Moody's Investors Service, January 2008.

Recommended Changes to the Bill as Introduced

The legislation that is the topic of this hearing today includes a provision for limiting debt service in a way similar – but not identical – to my recommendation in the debt letter. We have made a number of suggestions to the Chairman about changes to the legislation as written that will, we believe, ensure that the District maintains a sound fiscal footing. The two most important of those changes merit mentioning here.

First, we believe that the limit must apply to all of the District's tax-supported debt obligations, not just its General Obligation bonds. Rating agencies evaluate the burden from all tax-supported debt, not just GO bonds. Indeed, should it be determined that the newly authorized Income Tax revenue bonds can achieve lower debt service than GO bonds, we may choose to stop issuing GO bonds, at least as long as there is a financial advantage to the Income Tax bonds.

Second, we recommend that the ratio be based on expenditures rather than revenues. This, we believe, is a logical approach, easily understood by residents as well as credit analysts. Each year when the budget and financial plan is prepared, there will be a multi-year calculation of the amount allocable to debt service in each year.

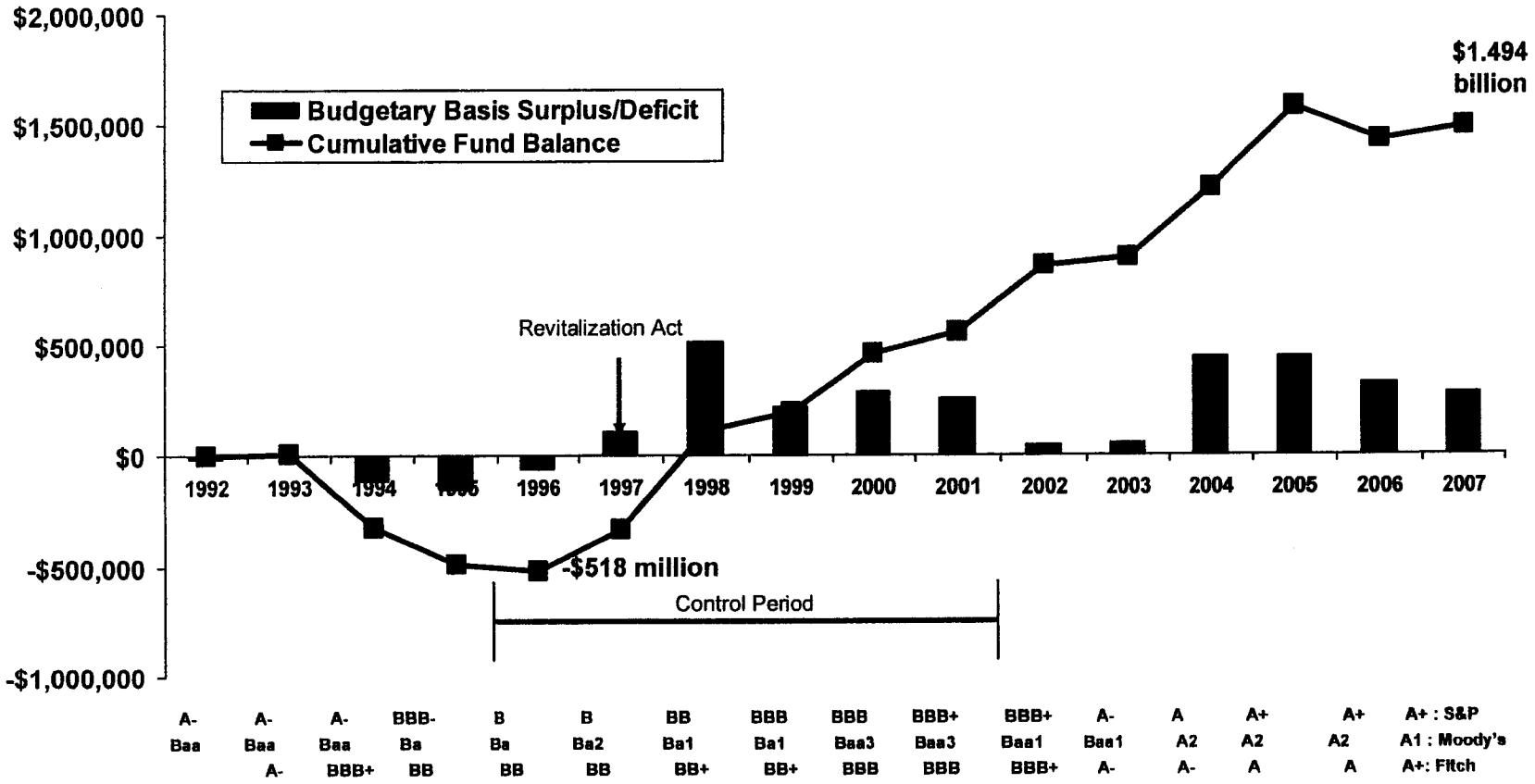
CONCLUSION

In summary, we recommend that the Council adopt this legislation with the suggested changes of the OCFO in order to ensure continuation of our city's financial flexibility. In these times of economic uncertainty, this is not only

preferable, it is essential to our ongoing fiscal stability. Mr. Chairman, we applaud the commitment to fiscal prudence demonstrated by you, the Mayor and the Council.

This concludes my remarks. I would be pleased to answer any questions you may have.

Surplus and Bond Rating History



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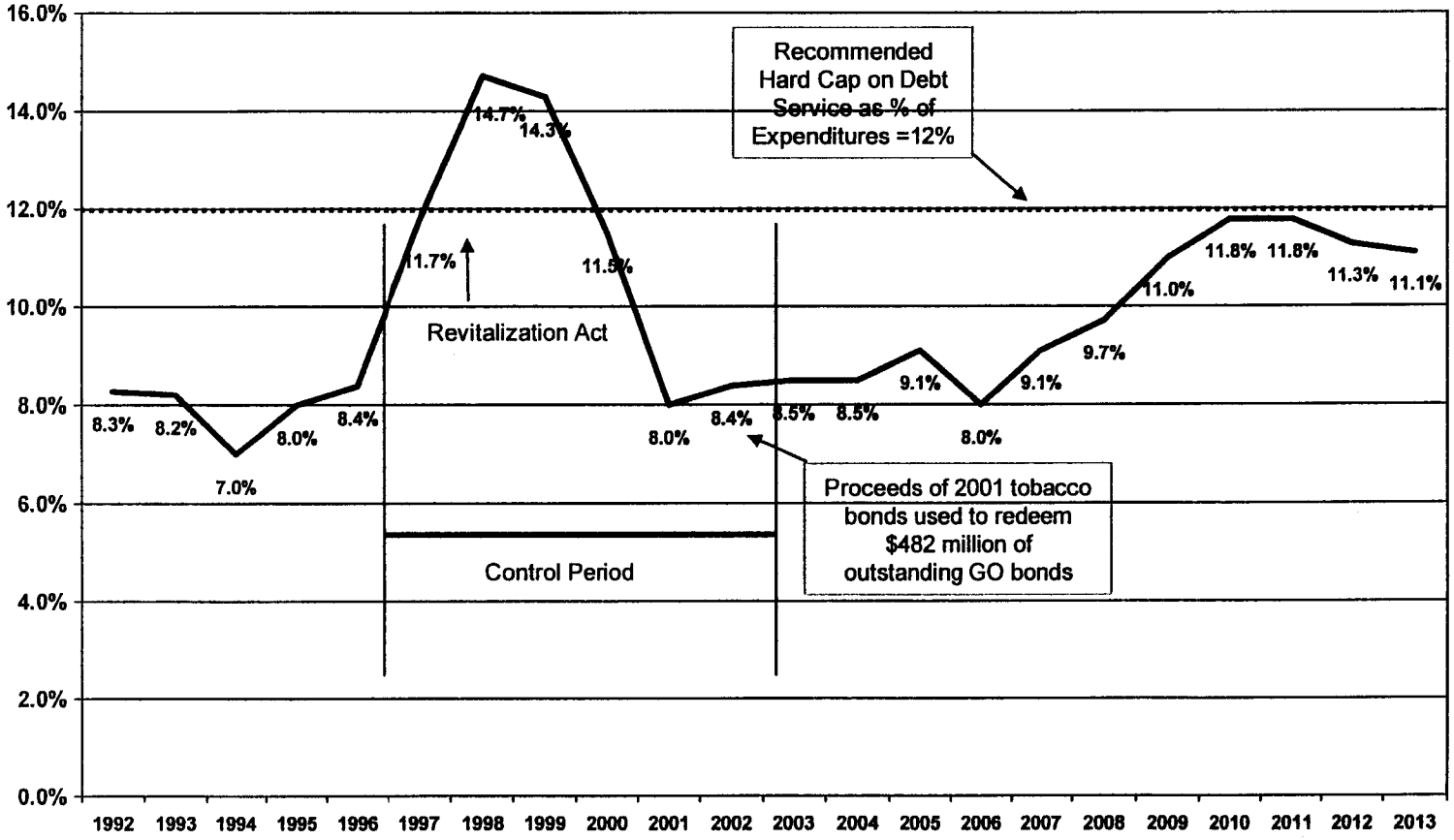
Growing Debt Burden

Debt Service as % of Expenditures

(as of September 30 of each fiscal year)