DRAFT

Attachment C

County Manager's Update on Debt Affordability
July 9, 2008

For many years, Arlington County has exercised prudence in the issuance of long term debt, which has resulted in Arlington's receiving the highest possible credit ratings from all three of the national bond rating agencies. Since 2002, Arlington has been guided by a set of County Board policies related to maximum debt levels. Earlier this year, the County Board expanded its "Financial and Debt Policies" to also consider debt affordability.

The recommended Capital Improvement Program (CIP) represents the outcome of the process established by the County Board to plan, fund, and implement capital projects over the next six fiscal years within the County Board's adopted policies. This report provides the current analyses that established the parameters for debt affordability for this CIP. Biennially, the CIP and this analysis will be updated in order to make amendments based on changing economic conditions – either favorable or unfavorable.

"Debt affordability" has been the primary policy focus of this CIP. Affordability is different from debt limits. As with a home mortgage, a bank may approve a very high credit limit; however, the critical questions are how much can one afford to pay each month and how many other expenses is one willing to sacrifice for the mortgage?

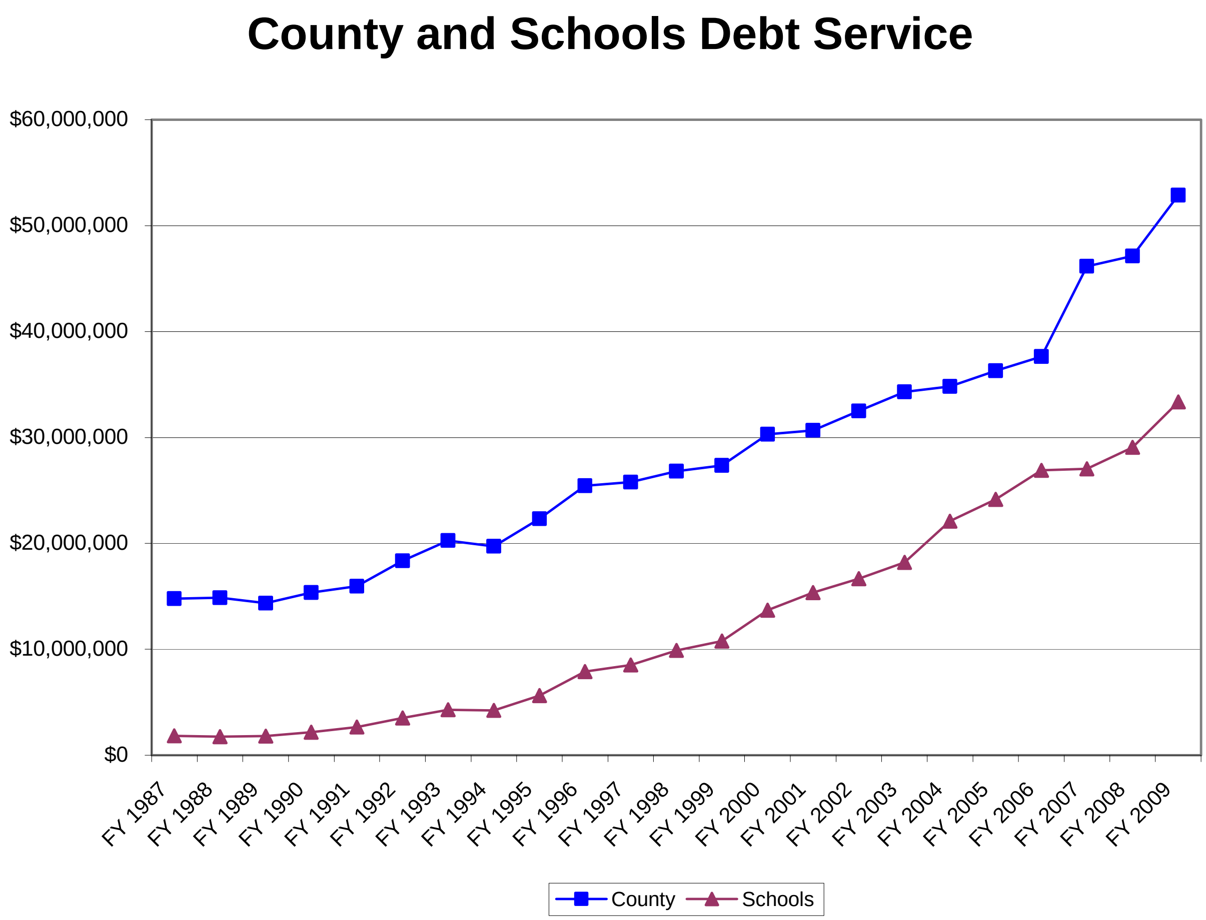
These are critical questions for a local government. Principal and interest from general obligation bonds are 20-year commitments and they are the first bills paid. Funds to meet these obligations are no longer available to maintain or expand services, to cover inflationary costs (such as fuel and energy), or to meet competitive compensation requirements.

The recently adopted County Board policy states the following: ***"Growth in debt service should be sustainable consistent with the projected growth of revenues. Debt service growth over the six year projection should not exceed the average ten year historical revenue growth."***

Recent Debt Growth

The central idea of this policy is that debt should not increase at a rate faster than the increase in revenue. This is to ensure that debt does not consume an increasing share of the budget – which it has in recent years. The policy establishes a cap that must then be evaluated in light of current economic conditions.

The following illustration shows how debt has grown in recent years and how it would grow into the future if no additional bonds were authorized by referendum. The combined County and Schools annual average debt service growth from FY 1991 to FY 1996 was 15.8%; from FY 1997 to FY 2002 was 8.7%; and from FY 2003 to FY 2008 was 9.0%.

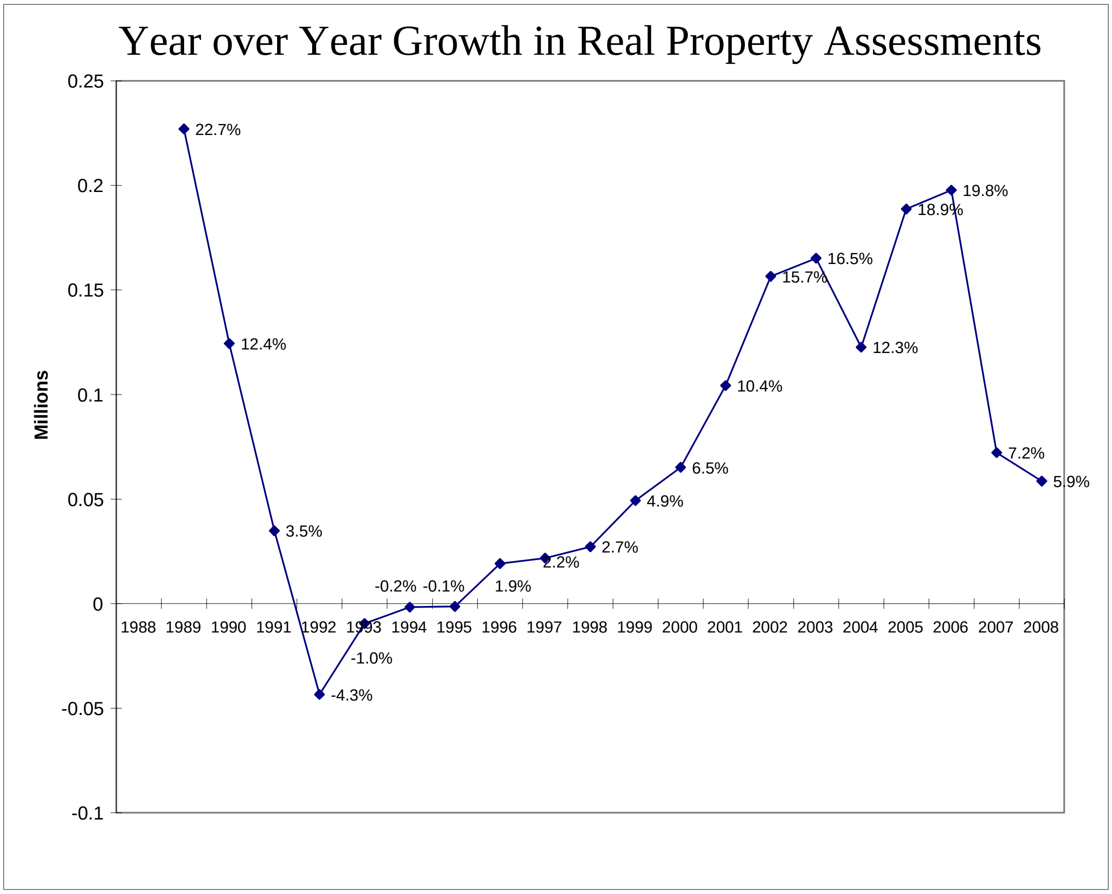


The above increases are not sustainable unless the County is willing to dramatically increase tax rates or severely reduce service levels.

Paying for Debt

Compared to other jurisdictions in Virginia, Arlington has relatively diverse revenue sources to support County services, including the Schools, which receive the County's largest appropriation. Nonetheless, the primary source of County revenue (approximately 50%) is from the real estate tax. Real estate taxes not only generate the most money, they are the only major revenue source over which the County Board exercises significant control. Most of the other major revenue sources have fixed rates or are capped by the state (sales, meals, transient occupancy, and business taxes). The personal property tax is the only other major tax where the County Board has meaningful discretion.

As illustrated in the following chart, the County's real property assessments are cyclical. During the early part of this decade we have seen the steepest increases since the 1980s. Similarly, we are also seeing a significant market correction. This correction was expected; in fact, the increase in values continued longer than one would have predicted. Based on past cycles and current real estate data, Arlington can expect to see slow to flat real estate growth in the immediate future. The County could also see a potential decline in assessments as experienced in the early 1990's. For example, during the County's most recent flourishing period from FY 2001 to FY 2006, we experienced average assessment growth of 15.9%. In comparison, during years of slow to declining growth from FY1991 to FY 2000, we experienced average growth of only 1.6%.



Based on these data, the question is what level of debt is affordable during the 2009-2014 CIP period?

The County Board policy established a cap based on the average ten-year historical revenue growth, which is 6.9%. However, we know that the 10-year average is distorted by the rapid increase in values from 2001 to 2006. There is no basis on which to project an increase of this magnitude during the next six years. To the contrary, we could see negative growth as happened for four consecutive years in the 1990s. For eight consecutive years in the 1990's, growth was <u>under</u> 4%. Today the real estate market is in a significant transition. While economic conditions in Arlington are as favorable as anywhere, we are not immune from market trends, as illustrated during the 1990's. Accordingly, there is no basis for projecting debt capacity beyond what is described in this report.

Based on the preceding, the recommended debt target for the 2009-2014 CIP is an average growth of 4%. This is recommended as a minimum level of investment for an expanding community with aging infrastructure. It also represents a reasonable level of growth to sustain a full-service local government. **However, it is a level that may not be achieved, resulting in a potential, significant revenue shortfall, which would require a combination of real estate tax rate increases and service reductions in order to maintain a balanced budget.** Expanding debt beyond the 4% level would significantly constrain the County and could jeopardize our credit ratings.

The following table summarizes the annual growth in debt payments during this cycle. While, the average increases meet the 4% target, there will be significant challenges to balance the budget in FY 2010 and FY 2011. These spikes are from projects to which the County and Schools have previously made commitments and for which voters have authorized debt. The slower debt growth in 2013 and 2014 for the County and in 2012 and 2013 for the Schools will provide critical capacity to meet other needs that will have to be deferred based on the very high debt increases in FY 2010 and FY 2011.

Annual Projected Debt Service Growth
(growth is year-over-year)

	FY10	**FY11**	**FY12**	**FY13**	**FY14**	**Annual Average Change FY09 - FY14**
Arlington County	9.6%	5.2%	4.8%	(1.5%)	1.9%	4.3%
Arlington Public Schools	8.3%	5.9%	(0.1%)	(3.4%)	5.3%	3.3%
Combined County and Schools	9.1%	5.5%	2.9%	(2.2%)	3.2%	3.9%

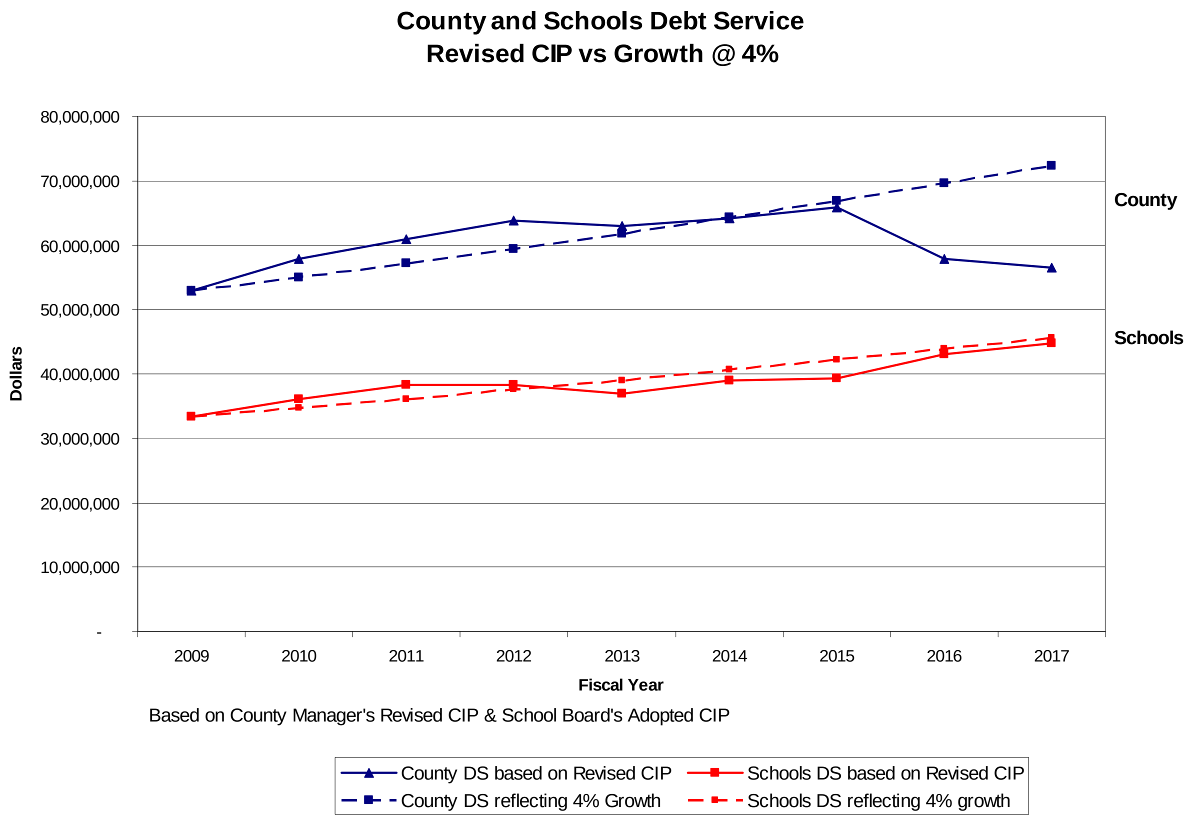
The following table shows the total amount of outstanding debt and the required budgets for each year. County debt peaks at over $65 million in FY 2015. School debt peaks at over $44 million in 2017. In 2012, combined debt will exceed $100 million for the first time and continues around that level for several years. To reiterate an earlier point, debt gets paid first, which means that $100 million in tax revenue will not be available for consideration to meet other County needs.

	County	Schools	Total
	Debt Service		
FY 2009	52,859,996	33,374,607	86,234,603
FY 2010	57,927,876	36,148,874	94,076,750
FY 2011	60,952,746	38,273,226	99,225,972
FY 2012	63,903,299	38,235,929	102,139,227
FY 2013	62,944,886	36,941,982	99,886,868
FY 2014	64,143,940	38,916,107	103,060,046
FY 2015	65,950,703	39,383,009	105,333,712
FY 2016	57,869,657	43,038,616	100,908,273
FY 2017	56,547,505	44,837,332	101,384,837

Note: Debt service cost estimates are based on the FY09-14 CIP assumptions and are subject to change as bond issuance assumptions change.

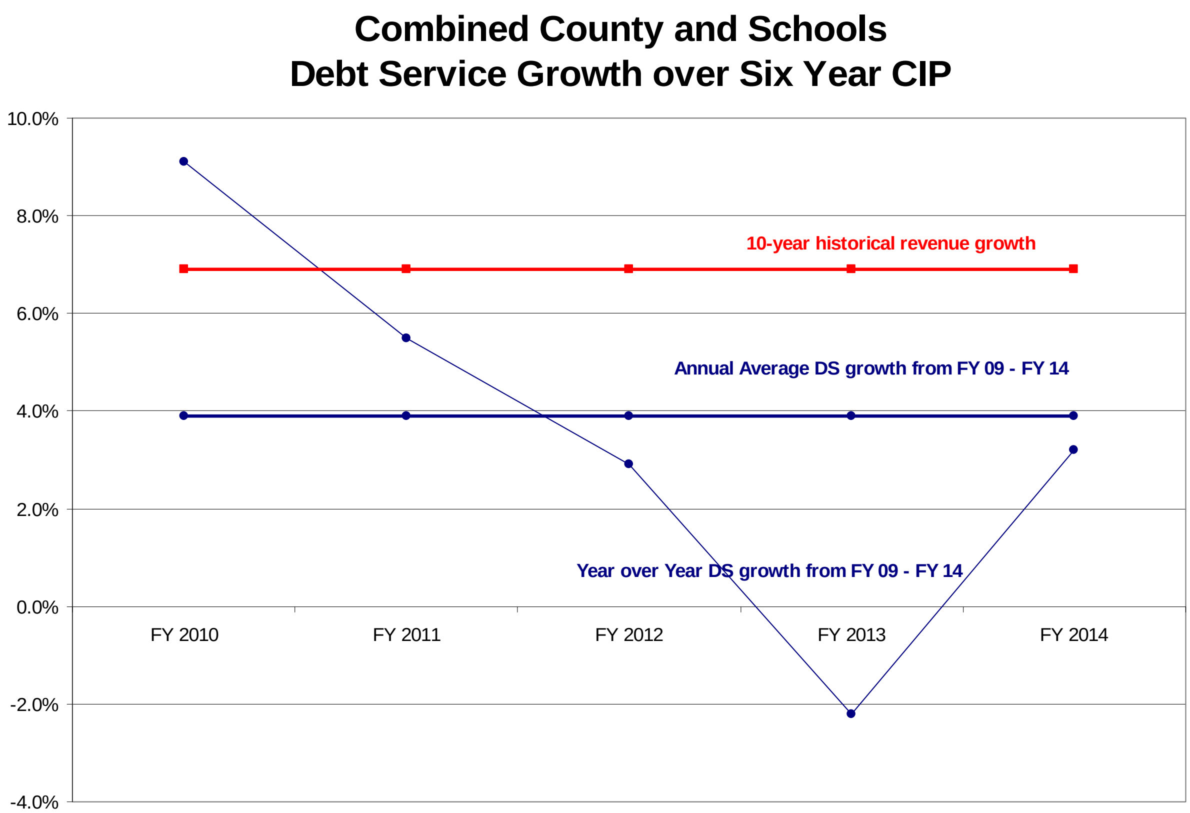
DRAFT

The following graph plots the growth in debt against the 4% target.



DRAFT

The following graph plots combined debt service growth, averaging 3.9% and within the 4% target for this period, against the average 10-year historical revenue growth. It, too, shows the spike in the near term overset by declining future increases.



Other Debt Ceiling Measures

The other County Board polices that are relevant to CIP are the following:

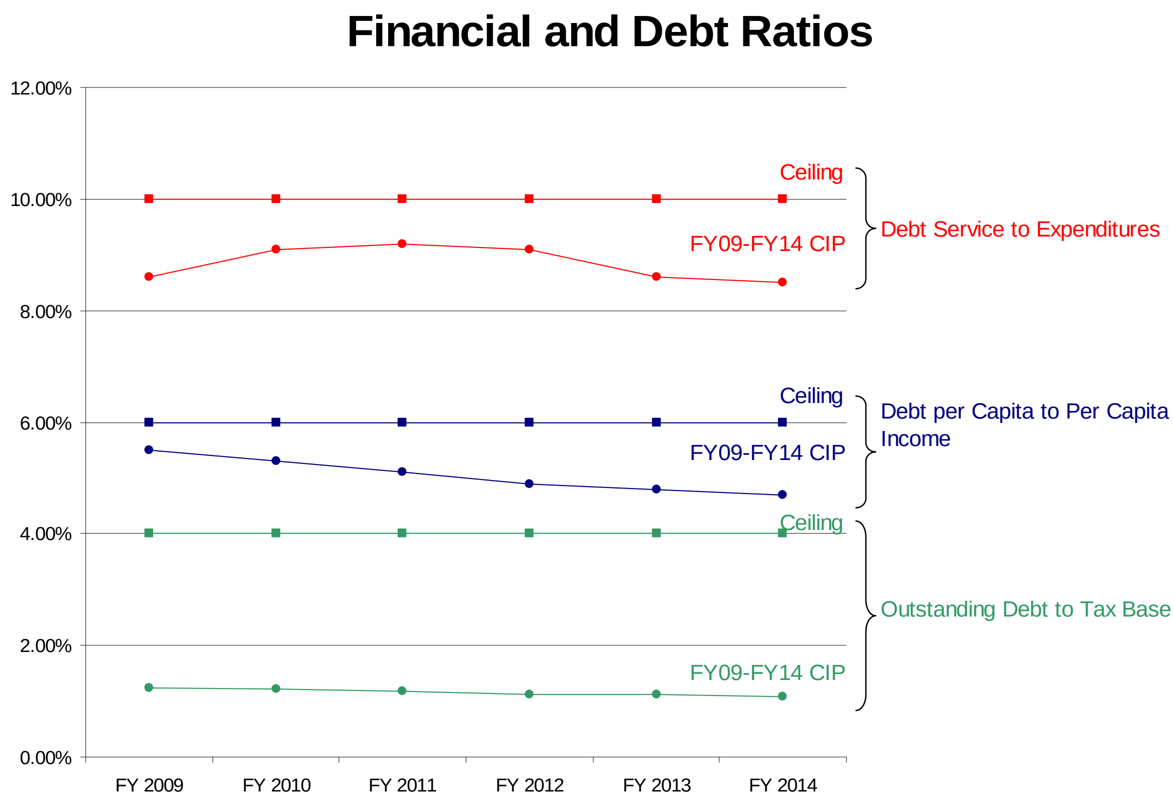
- **Ratio of Tax supported General Obligation and Subject to Appropriation Financing to Market Value of County Taxable Real and Personal Property No Greater Than 4%.** During the six-year period of this CIP, the County's outstanding General Fund serviced General Obligation Debt and Subject to Appropriation Debt as a percentage of Market Value of County Taxable Real and Personal Property is projected to peak at 1.24 percent in FY 2009. This ratio is projected to decrease to 1.08 percent by FY 2014. This is well within the four-percent ceiling.

- **Ratio of Tax supported Debt Service to General Expenditures No Greater Than 10%.** In FY 2009 for every dollar spent by the County and Schools, about 8.6 cents will be applied to debt service. The County estimates that in FY 2014 for every dollar spent by the County, 8.5 cents would be applied toward debt service. The Tax supported Debt

Service to General Expenditure debt ratio ceiling states that no more than 10 cents of every dollar spent by the County and Schools be spent on debt. If County debt were consistently near the 10% ceiling, the County would have very limited capacity to deal with an unexpected emergency need. Debt below 8% is highly desirable.

- **Ratio of Tax supported General Obligation Debt to Resident Per Capita Income No Greater Than 6%.** At the end of FY 2007 this ratio was 5.0 percent. The County estimates that the Debt to Income ratio will reach a peak level of 5.5 percent at the end of FY 2009 and come down to 4.7% by FY 2014. Arlington's self imposed target is significantly below the ratio average for local governments nationally and reinforces Arlington's triple-A bond rating.

The impact of the CIP on these measures is illustrated below.



Conclusion

This recommended CIP represents a fiscally responsible capital plan. It is consistent with the County Board's "Financial and Debt Policies." The plan represents continued reinvestment in the community at a significant level. The plan is affordable within reasonable revenue assumptions. However, the County will likely face some tough decisions on tax rates and service levels based on two factors: (1) spikes in debt services in FY 2010 and 2011 due to the timing of projects, and (2) overall economic conditions, especially in the real estate markets.

Modest tax rate increases to sustain at least a 4% growth in revenue are highly probable. Spending constraints and/or modest service reductions are also probable in the next two fiscal years.

Finally, all of the projections are based solely on what we know. Continued escalation of fuel and energy costs, fuel supply interruptions, State budget reductions to localities, State imposed constraints on local real estate taxes, and changing federal policies are important variables that are unpredictable. This is why the CIP is a plan that is reevaluated every two years.

For the next two years, the focus is on completing projects to which the County and Schools have previously made commitments. While the resources devoted to the projects over the next two years are significant, fulfilling previous commitments to the public represents a compelling policy reason to make funding them a priority. Doing so within the County’s financial policies not only ensures our ability to meet our financial obligations, but also to sustain our triple-A bond ratings.