CAPITAL BUDGETING AND WHAT YOU NEED TO KNOW

INTRODUCTION

- General operations of local government are financed through Current Fund appropriations (police, fire, admin., etc.)
- Capital improvements are financed through the Capital Fund (road imp., heavy equipment purchases)
  - Require large outlay of funds
  - Often financed by debt - Bonds or Notes
  - Minor capital improvements and some major capital projects may be financed by current fund appropriations.
    - "PAY AS YOU GO" VS. DEBT
    - KNOW YOUR BUDGET AND CAPITAL PLAN

CAPITAL BUDGET

- The identification of capital requirements of the municipality is the first step in the debt issuance cycle.
  - When the operating budget appropriation requests are being compiled and submitted by dept. heads, a list of capital needs for the ensuing years should be prepared.
  - The administrator, dept heads, or engineer should also prepare and update a capital plan
    - population less than 10,000 = 3 year plan
    - Greater than 10,000 = 6 year plan
- The DLGS requires the adoption of a capital budget where the cumulative cost of such items will exceed $25,000, for capital items with an expected useful life of 5 years or more.
  - This includes acquisition of land, heavy equipment, etc.
  - N.J.S.A. 40A:2-22 sets the useful life for such items.
- A bond ordinance can be adopted
  - only if a capital budget (or temporary capital budget) has been adopted,
  - or if a capital budget amendment has been passed.
    - The capital budget must be advertised (published) in the same manner as the official operating budget on forms prescribed by the DLGS.

CAPITAL BUDGET

- The Capital Budget contains the following information:
  - Project Title (Specificity is required)
  - Project Number
  - Estimated Total Cost
  - Amounts Reserved in Prior Years
  - Planned Funding Sources
    - Operating Budget
    - Capital Improvement Fund
    - Capital Surplus
    - Grants in Aid
    - Future Years Funding
- If priorities change during the course of a year, a bond ordinance is necessary, then the capital budget must be amended.
  - The capital budget must contain the above information, on forms prescribed by the DLGS.

STATUTORY DEBT LIMITS

- Municipalities and counties may incur debt only within certain limitations as defined by the Local Bond Law.
  - Must file a Supplemental Debt Statement as of the date of ordinance introductions
    - states debt outstanding, including the debt about to be authorized, and any debt activity during the year (payments and additions).
  - No municipal bond ordinance may be finally adopted if the supplemental debt statement indicates that the % of net debt exceed 3 ½ % of the average of the prior 3 years' equalized assessed real property valuations.
  - Counties have a 2% debt limitation.
  - School debt is limited to a maximum of 4% of the 3 year average for districts under a K-12 system.
- Said valuations are provided at the beginning of each year in the Municipal Information Sheet by the State of New Jersey – DLGS.

DEBT LIMIT EXCEPTIONS

- Exceptions to the debt limitations.
  - Refundings
  - Emergency
  - Self Liquidating
- The Local Bond Law provides for the Local Finance Board to approve so-called extensions of credit.
- Municipalities seeking to exceed their debt limit must submit an application on standard forms to the Local Finance Board.
  - include a list of projects contemplated and maturities,
  - the present debt service and outstanding debt, and the estimated annual debt service costs for the next 10 years.
- The Local Finance Board then holds a hearing on the extension of credit request.
  - The Board must determine that the improvements are in the public interest
  - that the amounts to be expended are not unreasonable or exorbitant
  - the issuance of such obligations will not materially impair the credit of the municipality or substantially reduce its ability to meet debt service payments.

PRACTICAL DEBT LIMIT

- DO YOU KNOW HOW MUCH DEBT YOUR TOWN HAS?
  - What is your percentage of Debt?
  - How much of your tax rate is committed to debt service?
  - How much debt can you afford
  - Is a pay as you go plan right for your community?
- Understand how much debt you have and how it impacts the tax rate
- What is the tax impact of new debt?
- Identify your capital needs (short & long term)
- Have a method to prioritize Capital Needs

PURPOSES FOR ISSUING BONDS

- Bonds may be issued for any capital improvement or acquisition of property:
  - Cannot bond "day to day" items
  - requires that the period of usefulness of the project to be financed by bonds be at least 5 years.
  - a maximum useful life of 40 years which applies only to certain types of buildings.
- The term of the bonds cannot exceed the life of the item being financed.
- The bond law also requires that a municipality provide a down payment of 5% of the amount of the obligations authorized.
  - the current year's budget appropriations
  - an emergency appropriation,
  - the capital improvement fund.
  - capital surplus
  - A waiver of the down payment is possible with Local Finance Board Approval.

PURPOSES FOR ISSUING BONDS

- In addition to the 5 year useful life requirement the purposes of debt obligations may also be viewed from the perspective of general or local improvements financed by bond ordinances.
- General improvements are paid from general municipal budget revenues, including property taxes.
  - Local improvements which specifically benefit certain portions (or properties) of a municipality are financed by special assessments against the property owner receiving the specific benefit.

PROCEDURE FOR AUTHORIZING DEBT

- Identification of capital needs
  - Preparation of Capital Budget
  - Capital Plan
  - prepare capital budget amendment, if necessary
- Supplemental Debt Statement
- Bond Ordinance is prepared
  - includes description -total amount and amount of debt authorized
  - period of usefulness -down payment
  - funding sources -Indicates Supplemental Debt Statement was filed properly
  - "Section 20" cost (soft costs)
- Introduced by majority vote (first reading only)
- published in "legal" newspaper at least ten day after intro to set hearing date
- public hearing/adoption
  - 2/3 vote of full membership
- after adoption
  - publish in paper
  - does not take effect for 20 days (allows for residents to challenge)
    - file a petition of at least 15% of registered voters (NJSA 40A:49-27)

SHORT TERM FINANCING

- Capital Purposes:
  - Types of notes authorized by the Local Bond Law, which may be used by the municipality, include:
    - Bond Anticipation Notes – These notes may be issued in anticipation of bonds, provided they have been authorized in the bond ordinance.
      - Notes may be issued for period not exceeding 1 year
      - may be renewed from time to time for periods not exceeding 1 year.
      - All such notes, including renewals, shall mature and be paid not later than the 10th anniversary date of the original notes.
        - Notes must mature and be paid no later than the 1st day of the 5th month following the close of the 10th fiscal year.
      - Annual installment must be paid from the 3rd Anniversary date for principal payments.
      - Interest payments must be made annually including the 1st 2 years.

MINIMUM BAN PAYMENTS

Year	Minimum Payment	Equal Payment
2017		$50,000
2018		$50,000
2019	$26,315	$50,000
2020	$26,315	$50,000
2021	$26,315	$50,000
2022	$26,315	$50,000
2023	$26,315	$50,000
2024	$26,315	$50,000
2025	$26,315	$50,000
2026	$26,315	$50,000
	$210,520	$500,000

- Minimum Payments on Notes are Required by Statute
- Minimum Payments won't Pay off the Amount Due
- Paydown Options should be considered when Authorizing the Improvement
- A well thought out Capital & Debt Plan will consider the pay down of debt over a reasonable time period.

SHORT TERM FINANCING

- Special Assessment Notes – Notes may be issued to finance local improvements or special assessments.
  - may be renewed for periods not exceeding 1 year
  - shall mature and be paid not later than the 5th anniversary of the date of the original notes.

- Capital Notes – A municipality may finance an improvement by the issuance of capital notes.
  - The total amount of all such capital notes outstanding at any 1 time may not exceed $200,000 or ½ of 1% of the equalized valuation basis, whichever is less.
  - Notes must mature 5 years from the date of issuance
  - and 1/5th must be paid annually.

SHORT TERM FINANCING

- Operating Purposes:
  - The Local Budget Law permits municipalities to borrow money on a short term basis to meet budgeted operating needs when cash flow shortfalls occur or when regular or special emergency appropriations are authorized.
    - Tax Anticipation Notes (TANS) – The Local Budget Law permits a municipality to issue tax anticipation notes in anticipation of the collection of taxes in any fiscal year.
      - TANS may be renewed, but all notes shall mature in the case of the municipality not later than March 31 of the succeeding fiscal year and
      - in the case of a county not later than June 30 of the succeeding fiscal year.
    - Emergency Notes – The Local Budget Law also permits a municipality to issue notes to meet an emergency appropriation.
      - Such notes must be authorized by resolution of the governing body
      - and may be renewed.
      - The notes must mature not later than the 1st day of the fiscal year succeeding the fiscal year in which such notes were issued and the emergency appropriation authorized.

SHORT TERM FINANCING

- Special Emergency Notes – The Local Budget provides for the issuance of special emergency notes to finance special emergency appropriations for:
  - tax maps, master plans, codifications, and revaluations.
  - The notes may be renewed, but at least 1/5th must mature annually and must be included in the annual budget.
  - The notes are authorized by a resolution adopted by 2/3rds vote of the full governing body.

- All BANS & Capital Notes may be sold on the basis of negotiation
  - it is not necessary to advertise and receive bids for the sale of notes as is the case of bonds.
  - It is recommended that competitive proposals be received to ensure the best possible interest.

THE SALE OF BONDS (LONG TERM/PERMANENT FINANCING)

- Bonds must be sold by public sale.
  - A municipality must advertise and receive bids with the following exceptions:
    - 1. the total amount is less than $1,000,000,
    - 2. there are no bidders,
    - 3. they are refunding bonds, or
    - 4. they are sold to a political subdivision of the state or to an agency of the federal government.
- The sale of municipal bonds is sometimes complex requiring adequate preparation and careful planning including a thorough review of the "Local Bond Law".
  - Advice should be sought from the municipality's bond counsel, bankers, financial consultant, and bond underwriters.
- All bonds issued by the municipalities must be in registered form,
  - whereby the individual or firm purchasing the bond registers their name, address, and social security # with the municipality or its registration agent.

THE SALE OF BONDS (LONG TERM/PERMANENT FINANCING)

- Preparing for a bond sale
  - Contact bond council early
    - List of potential bidders (underwriters) should be notifed
    - Notice sent to The Bond Buyer and local paper
  - Official State Preparation (OS)
    - Notice of Sale
    - Socioeconomic Information
    - Financial Information about the community (audit schedules and other schedules as needed)
      - Rating Agencies will require this information
  - Schedule of bond maturities must be prepared
    - Equal annual debt service (P&I may change, but total remains constant)
    - Equal annual maturities
      - Local Bond Law requires all bonds must mature in annual installments
        - No annual installment may exceed 100% of the amount of the smallest installment
        - Need LFB approval for non conforming issues (back loading)

THE SALE OF BONDS (LONG TERM/PERMANENT FINANCING

- Form of bids
  - Formal Sealed Proposals
    - Similar to regular bid process
    - May take time to calculate to various maturity schedules
    - Award is based on net calculation
  - Electronic
    - Must register with an approved auction house
      - Potential bidders must register and provide a good faith deposit
    - Electronic tends to allow for more bidders
    - Allows underwriters to make last minute changes
    - Real Time
      - Bidders know where they stand (based on NIC)
      - May change bids as many times as they wish
      - "two minute" rule

BOND RATINGS

- Bond or credit ratings are simply an expression of the odds of loss to the investor.
  - A rating is concerned with the security and the safety of the bonds.
- The investor is concerned with being protected against inordinate increases in debt and in the consequent ability of the municipality to meet the debt service requirements.
  - The rating assigned to a municipality’s bonds assists the investor in determining the amount of risk in purchasing a municipality’s bonds.
- Bonds with a higher (better) rating generally carry a lower interest rate because the debt is better secured and has a higher probability of being repaid than lower rated bonds.
- A municipality cannot purchase a bond rating.

MUNICIPAL BOND INSURANCE

- Municipalities have also been able to reduce their interest costs by having their bonds insured.
  - Municipal bond insurance is a "voluntary cost of issuance" which assures payment in case of default.
- The insurance policies issued by these companies guarantees payment in the event of default by the municipality.
  - Even municipalities with an A rating may find it attractive to purchase bond insurance.
- The cost of the insurance has to be weighed with the benefit of having a higher bond rating.
  - Rating firms usually rate bonds at the highest investment grade if they are insured.

RATING OF MUNICIPAL BONDS

- In order to rate the bond issue the rating agencies require a large amount of data from the municipality, including the following:
  - 1. Annual financial reports for at least the last three years
  - 2. Interim financial statement
  - 3. Annual budget for the current year, both operating and capital
  - 4. Listing of long term debt of all types, with each type identified and details given
  - 5. A comparison of outstanding debt of all types over a period of ten years

RATING OF MUNICIPAL BONDS

- 6. Schedule of annual bond principal maturities by class of bonds
- 7. Identification of overlapping debt, if any
- 8. Comparative trends of past debt service and those planned for the future
- 9. Full text of enabling bond ordinance
- 10. Ten year trend of assessed valuations of real property

RATING OF MUNICIPAL BONDS

- 11. Ratio of assessed valuations of real property to market value (true value)
- 12. Tax Rates, for the borrowing unit and the overall rate for all local governments such as city, school, county and districts
- 13. Tax collection record for the past five years, including interest charges and frequency of tax sales
- 14. Special details of utility operations, if any, including physical facilities; record of output and consumption patterns, rate schedules and service rules
- 15. Economic and demographic data that can serve to identify resources of the community, sources of personal and business income, past and current trends

RATING OF MUNICIPAL BONDS

- 16. Population
- 17. Extent of retail, commercial, industrial zones
- 18. Summary of local building code, zoning and land use
- 19. Range of selling prices for new residential construction
- 20. Judgments against municipalities

QUALIFIED BONDS

- The credit of certain municipalities was strengthened by the Municipal Qualified Bond Act (NJSA 40A:3-1)
  - provides that a municipality may "pledge" its anticipated revenue from certain State Aid programs to the payment of principal and interest on bonds.
    - These revenues include State urban aid funds and business personal property replacement funds.
- The State Treasurer pays directly to a municipality's paying agent, rather than to a municipality, a pre-determined amount of State aid entitlement for purposes of making principal and interest payments on bonds.
  - Local Finance Board Approval is required
  - Gross amount of state aid is anticipated and gross debt is appropriated

REFUNDING BONDS AND ARBITRAGE

- Refunding issues or "advance refunds" are bonds sold to refinance existing debt before that debt either matures or is eligible for redemption to N.J.S.A. 40A:2-52, 53 et seq.
- The technique is used in both general obligation and special assessment issues.
- Refunding occurs most often when the interest rate level moves low enough to sell new bonds that will have lower cost to the issuer.
  - Most bonds have a "call" feature
- New regulations by the IRS have been instituted to curb the practice of "arbitrage" which had been part of refundings.
  - Arbitrage is the practice of borrowing funds at a relatively low rate and investing the borrowed funds at a higher rate.
  - The difference between the rates is arbitrage.
  - The practice is strictly prohibited by the IRS.
    - Therefore when a "refunding bond ordinance" is planned, bond counsel must be consulted with regard to arbitrage and the need for a written opinion including compliance with IRS regulations.