July 14, 2010

To: Finance & Budget Committee

From: Peter Harris, Central Staff

Re: Response to SLI on the use of reserves vs. debt for periodic replacement of City equipment

Introduction

Statement of Legislative Intent (SLI) 86-1-A-1 called for a report on the relative benefits of reserves and debt in paying for the periodic replacement of City equipment, including computer hardware and software. A reserve is simply a fund in which money is collected over some years in advance of purchasing the new equipment.

The City Budget Office (CBO) responded to the SLI with the attached report. The report reviews existing policies and practices. In general, the City's debt management policies discourage the use of debt for equipment replacement. Departures from policy occasionally have been justified when the need for the equipment is immediate and unanticipated and the term of debt is short, keeping interest costs low. The CBO report does not make any specific recommendations. It says the "current policies on debt . . . are reasonable in that long-term targets are established, while also allowing for flexibility." It gently suggests that the City "may wish to establish additional mechanisms that would place an even greater focus on using current resources in lieu of debt when fiscal conditions are favorable."

Below I will first describe some assumptions that form the context for this discussion. Then I will excerpt the current policies that concern the purposes and use of debt. In the conclusion I will suggest that reaffirming the existing policies and realizing them in the upcoming budget may be more useful than revising the policies.

Five assumptions

First, the scope of this discussion is limited to the replacement of expensive equipment, such as computer hardware, which must be replaced periodically and for which a business need is well established. In this context, expensive means that buying the new equipment with cash in one year would require a significant one-year increase in the department's budget, and a significant increase in the rates charged to any customer departments, or a significant one-year cut in other department services.

This leads to the second assumption, which is that smoothing the cost of expensive equipment over the life of the equipment is a good thing, because it avoids the disruptions of budget and rate fluctuations. One way to smooth costs is to pay for the equipment with debt issued for a period equal to the life of the equipment. Another is to save up for the purchase by collecting reserves, either in a fund dedicated to the replacement of the specific equipment, or in an enterprise fund from which a variety of equipment and other things are purchased.

The third assumption concerns the rate at which future costs are discounted and the effect of this on the relative cost of reserves and debt. The CBO report shows that reserves are cheaper than debt when the discount rate is lower than the interest rate on debt, and more expensive when the discount rate is higher than the interest rate. It describes the discount rate assumption as "highly subjective, particularly within a public sector context." We might remove some of the subjectivity by considering one aspect of what it means to be fiscally sustainable. If sustainability means valuing the future as much as the present, then a fiscally sustainable discount rate is one that is no higher than inflation. As a rule, because bondholders will demand a return over inflation on their investments in City debt, a fiscally sustainable discount rate will make reserves cheaper than debt.

Fourth, from time to time the City might want to pay the extra cost of short term debt in order to help smooth its total costs over a dip in the economy and a resulting dip in City revenue. Whether this is prudent depends on whether the economy will turn around before the debt is paid. If not, debt will only dig the hole a little deeper.

Fifth, one disadvantage of reserves in comparison to debt is that reserves require earlier planning, and planning is not always accurate. If we collect too little, we have to make up the difference. If we collect too much, we suffer an opportunity cost. When replacing existing equipment, however, these risks should be small, and may be outweighed by the general benefits of planning in giving us a longer and more comprehensive view of equipment needs.

Debt management policies

None of the existing City policies on the use of debt prohibits the use of debt for equipment replacement, but all suggest it is undesirable.

General debt management policies were most recently updated in 2001 by Resolution 30345. One of the primary policy objectives is to minimize debt service and issuance costs, and another is to retain the highest practical credit rating. Both imply that it is good to minimize debt. Policy #7, on capital financing, says this:

> "The City will normally rely on existing funds, project revenues, and grants from other governments to finance capital projects such as major maintenance, equipment acquisition, and small development projects. Debt may be used for capital projects only when a project generates revenues over time that are used to retire the debt, when debt is an appropriate means to achieve a fair allocation of costs between current and future beneficiaries, or in emergencies."

Regular equipment replacement normally would not qualify under the exceptions in the second sentence, especially as an alternative to reserves.

Resolution 30392, also adopted in 2001, updated the financial policies for the non-utility departmental operating funds. Debt is a topic in the policies for the Fleets & Facilities Fund and Information Technology Fund. For each of these there is a policy on the use of debt which says,

> “Cash shall be preferred to debt for financing major maintenance and replacement, and [options for charging customer departments] that assume cash financing of these projects shall be provided to the Council.”

In addition, Fleets & Facilities policy #8, on capital and major maintenance funding, says,

> “For each subfund, F&FD will propose charges that cash finance major maintenance and replacement demands.”

Fleets & Facilities policy #12, on the capital component of lease rates, says,

> “The Council directs the Executive to set the capital component of fleet leasing rates in each year over a biennium to cover the average annual capital replacement needs over the next five years.”

Fleets & Facilities policy #14, on the centralized City fleet, says,

> “For all General Fund vehicles, vehicle replacement costs will be included in the leasing rates charged.”

Information Technology policy #6, on separate cash accounts, anticipates the collection of reserves for equipment replacement:

> “In each case where DoIT receives revenues . . . to replace capital assets, the department will evaluate the desirability of placing these revenues into a separate cash account within the Information Technology Fund.”

Conclusion

City financial policies are agreements between the City and itself. Exercises in reviewing financial policies typically reaffirm the virtues of prudence and planning for the long term. They also typically recognize the desire for some flexibility; hence the terms “normally” and “preferred” in the policies quoted above. The CBO suggestion that we might consider “additional mechanisms that would place an even greater focus on using current resources in lieu of debt when fiscal conditions are favorable” reflects the same balance.

In this case, unless the Council wants to eliminate flexibility, it is not clear that new or revised policies would be more effective than a reminder of the policies that already exist and the reasons for them. Policies that would strengthen the bias against debt when fiscal conditions are favorable may somewhat miss the point, as the temptation to use debt is strongest when fiscal conditions are unfavorable.

The timing of a reminder now is good, because financial policies traditionally are also agreements between the Mayor and Council. The best way to reaffirm the existing policies discussed here would be for the Mayor to propose a budget that funds equipment replacement with cash or reserves rather than debt, and for the Council to respect these reserves when it adopts the budget.