



City of Seattle
City Budget Office

MEMORANDUM

To: Councilmember Jean Godden, Chair
Finance and Budget Committee

From: Beth Goldberg, Acting Budget Director

Date: April 1, 2010

Subject: **Response for Statement of Legislative Intent 86-1-A-1 regarding use of reserve funds vs issuing debt for periodic replacement of city equipment, hardware, software, etc.**

Summary

Statement of Legislative Intent 86-1-A-1 requested that the Department of Finance (DOF), now City Budget Office (CBO), report back to the Council to address City policy on how best to pay for periodic replacement of City equipment, hardware, software, etc.

The City employs a variety of strategies to finance replacement of equipment, hardware and software. Strategies used reflect the nature of the replacement and account for characteristics such as timing, magnitude, lifespan, and fiscal conditions. Flexibility within existing financial policies allows departments to respond to changing and challenging fiscal conditions.

Some changes in policy could be made that would better allow the City and its departments to weather downturns in the economy, increasing future flexibility and preserving limited debt capacity, as discussed below. CBO and the Executive will continue to analyze potential policies around this issue in the development of the 2011-2012 Proposed Budget.

If additional information is requested beyond what is covered below, please do not hesitate to contact me at beth.goldberg@seattle.gov, or (206) 233-7115.

Detail

Existing financial policies

Many of the City's financial policies pertaining to use of councilmanic debt are contained within Resolution 30345, adopted in 2001 (as amended by Resolution 30630 in 2003). This resolution states that the City shall generally rely on existing funds, project revenues, and grants from

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other entities to finance capital projects such as equipment acquisition. It directs that debt should be used primarily for revenue-generating projects, emergencies, or to allocate costs over time for projects with a useful life of more than five years. It further states that the City expects to make a cash contribution to projects with a lifespan of less than ten years instead of relying on 100 percent debt financing. Resolution 30345 further states that eligible uses of councilmanic debt include those projects that are expected to reduce City operating costs within five years, projects under \$10 million, and projects that provide essential city services where the value of the service overrides a public vote.

Resolution 30392, also adopted in 2001, directs the Fleets and Facilities Department and the Department of Information Technology to adopt a goal of using debt primarily to acquire assets costing in excess of \$1 million and having a useful life of five or more years. These assets may also be acquired by cash if supported by fiscal conditions. In limited cases, debt may be used to fund other assets. Cash shall be preferred to debt for financing major maintenance and replacement, and proposed rates are to assume this in most cases.

Various practices across departments

Over the last few years, DoIT has used several different approaches to cover the cost of replacing equipment, hardware and software. These include:

- a. For smaller, ongoing, asset/equipment replacements, DoIT has typically used its fund balance to finance the up-front cost of purchasing assets/equipment. If the purchase of the item qualifies as an asset, the fund balance is then replenished over the estimated life of the asset by building the depreciation expense into DoIT rates. If the purchase does not qualify as an asset, the full cost of the equipment is built into DoIT rates or allocations in the year of the budgeted purchase.
- b. Alternatively, DoIT has utilized short-term debt to fund the acquisition/replacement of more expensive/significant assets/equipment. Examples of this include the initial Storage Area Network purchase (2002-2003), IVR replacement project (2009-2010), Enterprise Computers and Storage in 2009-2010, initial UDS build-out, Data Center build out, and the GroupWise to Exchange Migration Implementation project (2009-2010). Items funded in this manner are typically monetarily too large to be handled by DoIT's fund balance.
- c. A third option – reserve funds – has been used less frequently. The one reserve fund that DoIT has historically maintained is for the regional radio system and the related public safety handsets. The infrastructure portion (for the replacement of the network/network components) of the reserve is mandated by the regional partners under the inter-jurisdictional agreement governing the network. In addition, the City has historically chosen to have DoIT collect and manage reserves for the replacement of SFD and SPD radios.

Originally, in the 2009-2010 budget, DoIT (with agreement from DOF) was seeking to move some of the large equipment replacement funding (for the Enterprise Computers and Storage and the IVR System) from a debt financing model to a reserve fund model. This decision was reversed due to the budget shortfall and we reverted solely to the debt financing model on those items.

Other examples include FFD/FAS and the central fleet for the City. Departments pay a lease rate to FFD/FAS, which manages a capital replacement fund and makes purchases for most City departments. In this way, operating expenses in operating departments stay relatively

smooth over time, while the actual capital purchase pattern from the Fleets spike depending on how many vehicles need replacement in a given year.

SCL and other departments will fund equipment and hardware replacement internally, after developing appropriate lifecycles. For instance, SCL has a replacement cycle for computers (5 years). In their base budget, they've calculated the cost of replacing computers on a 5-year phased approach, and the budget reflects this cost evenly throughout the five-year span. If costs go up, or the budget is used for something else, the replacement cycle gets longer (unless additional funding is granted to bring it back up to speed). City Light electrical vault maintenance is on a similar repair schedule – 4 years, in this case. Streetlight maintenance and relamping is on the same schedule, too.

Pros and Cons of sinking reserve funds vs debt

Strategies that utilize reserve funds and debt are similar in that both methods allow for significant moneys to be spent at one time, but supported with contributions over time.

The primary benefit of a debt strategy vs a reserve strategy is that an asset can be acquired sooner than through a reserve fund strategy. If a reserve is used, the reserve must first be built up sufficiently. For projects where timing is less flexible and funding is needed in the near-term, a reserve strategy may not be workable. In some cases, a favorable purchasing environment may warrant the decision to move ahead with a debt strategy even though the acquisition could be delayed until a sufficient reserve was established. In a down economy, when excess cash is not available, debt financing may be the only option for projects that cannot be delayed nor financed with existing resources.

One drawback of a debt strategy relative to a reserve strategy is the inflexible obligation of debt service. While debt repayment plans can be structured in a variety of ways, in general the structure must be adhered to unless a refinancing approach is implemented. The funding of a reserve can be altered as needs and priorities change, allowing more flexibility in the interim. Another advantage to a reserve strategy is rate path stability for the rate payers. Debt service payments generally involve a shock in the rate path, that may be difficult for rate payers, particularly during times of decreasing budget allocations. Additionally, unrestricted funds set-aside for a particular purpose can be used for another purpose if needed, whereas excess funds acquired from a debt issue are less malleable. This may come into play in a down economy, where flexibility is needed to support operations. If a large portion of resources are dedicated to debt service when revenues are slowing, then that leaves a smaller portion of resources with which to prioritize for other priorities.

A reserve fund can be particularly useful when there are periodic and ongoing costs that need to be financed, as opposed to a large expenditure at a single point in time. This is the case with staggered life-cycle replacement, where equipment is continuously being replaced, and funding is needed over time. A reserve can also be useful when a future need is known in advance and manageable contributions can be set-aside for a future purpose.

A net present value assessment of a reserve vs debt approach is considered below. If the interest rate equals the discount rate, there is no difference between the NPV of using a reserve vs a debt approach. Consider a \$500,000 investment in year 5 and a discount and interest rate of 3%. From a NPV perspective, although the debt strategy results in \$75,000 more in nominal dollars of resources committed, because these resources are committed at a later time and their time-weighted value is less, both strategies have an initial year NPV of \$431,304.

Interest Rate 3.00%
Discount Rate 3.00%

Year	Debt Scenario		Set-Aside Scenario		
	Debt Service	Bond Revenue	Contributions	Interest Earned	Available
1	\$0	\$0	\$94,177	\$0	\$94,177
2	\$0	\$0	\$94,177	\$2,825	\$191,180
3	\$0	\$0	\$94,177	\$5,735	\$291,093
4	\$0	\$0	\$94,177	\$8,733	\$394,003
5	\$0	\$500,000	\$94,177	\$11,820	\$500,000
6	\$109,177	\$0	\$0	\$0	
7	\$109,177	\$0	\$0	\$0	
8	\$109,177	\$0	\$0	\$0	
9	\$109,177	\$0	\$0	\$0	
10	\$109,177	\$0	\$0	\$0	
Nominal:	\$545,886	\$500,000	\$470,886	\$29,114	\$500,000
NPV:	\$431,304	\$431,304	\$431,304		

The limitation of net present value analysis is that the results are very sensitive to the discount rate assumption, which itself, is highly subjective, particularly within a public sector context. Consider the following example, where the debt scenario has a lower NPV (\$370,358) when compared to the set-aside scenario (\$407,738). In this circumstance, the debt scenario provides the lower cost to the City in NPV terms, even though the nominal dollar amount required for debt service (\$545,886) would exceed the nominal contributions required for the set-aside (\$470,886). On the other hand, if the current rate of return on the City's cashpool (1.2%) is used as the discount, the set-aside scenario would cost less than the debt scenario.

Interest Rate 3.00%
Discount Rate 5.00%

Year	Debt Scenario		Set-Aside Scenario		
	Debt Service	Bond Revenue	Contributions	Interest Earned	Available
1	\$0	\$0	\$94,177	\$0	\$94,177
2	\$0	\$0	\$94,177	\$2,825	\$191,180
3	\$0	\$0	\$94,177	\$5,735	\$291,093
4	\$0	\$0	\$94,177	\$8,733	\$394,003
5	\$0	\$500,000	\$94,177	\$11,820	\$500,000
6	\$109,177	\$0	\$0	\$0	
7	\$109,177	\$0	\$0	\$0	
8	\$109,177	\$0	\$0	\$0	
9	\$109,177	\$0	\$0	\$0	
10	\$109,177	\$0	\$0	\$0	
Nominal:	\$545,886	\$500,000	\$470,886	\$29,114	\$500,000
NPV:	\$370,358	\$391,763	\$407,738		

The costs of a debt solution are understated above in that they do not take into account issuance costs. Issuance costs tend to be a relatively smaller portion of the total cost for larger projects.

The use of debt may restrict flexibility in the future, a drawback of relying too heavily on debt, especially in a down economy.

How might the city revise its financial policies to address this issue?

Financial policies should reflect fiscal prudence as well as take into account operational considerations. Departments that employ a life-cycle cost replacement strategy generally do so in order to provide stability to annual contributions, but also to allow for flexibility to address short-term fluctuations in resources or expenditure needs. This approach continues to seem prudent.

DoIT continues work to flesh out a comprehensive Asset Management Plan which will help to categorize the complex and varied IT assets that the City must manage and how best to approach this task. This plan will include additional analysis about appropriate funding strategies.

The City's current policies on debt in general are reasonable in that long-term targets are established, while also allowing for flexibility to accommodate various fiscal circumstances. This is evidenced in the City's policy on debt service, which is targeted not to exceed 7% of revenues in the longer term, but that can reach as high as 9% in any one year.

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. This would preserve the ability to make more use of debt financing in later years if fiscal challenges are experienced.

Resolution 30345 might be amended to further define what is contemplated by an initial cash contribution to a debt-financed project with a lifespan of less than 10 years. One approach would be to articulate a desired target minimum initial cash contribution for such projects when fiscal conditions allow, such as the lower of 30% of a project's cost or \$1 million. This would have the effect of reducing fixed obligations in the future. Another approach would be to create a policy that would set aside excess revenue in a fund beyond budgeted assumptions that is intended to be used in order to reduce future reliance on debt, rather than current policy which directs that excess revenues should result in reduced rates in the following period. This would help transition project financing from debt to use of reserve funds. If a reserve strategy is pursued, specific policies about the use of the funds set aside would be required.

Another consideration would be that dollar amounts established in 2001 may be increased to reflect natural inflation, or indexed to allow for natural growth in these guides over time. As an example, the \$1 million floor for debt financed projects might be increased.

Impact of a change in policy

Depending on the nature of the change, any or all departments could be impacted. This would be especially true if a central rate agency were to alter its funding strategy, which may result in changes to central cost allocations. This might have the effect of increasing or decreasing any particular department's costs.

Specific equipment, hardware and software replacement needs include those mentioned above, as well as other projects such as an eventual upgrade of the City's financial system, periodic

upgrades to Microsoft software, including operating systems and the Office Suite. Servers, computers, monitors, and other IT equipment require periodic replacement.

Given the broad array of projects and financing strategies utilized by City departments, there are a wide variety of possible outcomes depending on the approach taken in altering financial policies. CBO is available to provide further analysis of specific concepts.